Task Force on the Future of the Canadian Financial Services Sector

September 1998

change challenge opportunity

Competition, Competitiveness and the Public Interest

Background Paper #1

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Chapter 1

Introduction

Broad forces of change are impacting the world on an unprecedented scale. Extraordinary advances in technology have unleashed an information revolution which is expected to continue well into the next century. This availability of information worldwide, instantaneously and at low cost is underpinning and supporting the extraordinary changes that are taking place in social and economic systems. As the President of the World Bank recently commented:

> Ten to 15 years ago, one country in four had a democratic government. Today it is two in three. Ten years ago, a billion people lived in a market economy. Today 5 billion people live in a market economy.[1]

The information revolution is also affecting businesses worldwide as they attempt to meet diverse and sophisticated consumer demands in a marketplace that is increasingly global.

No sector appears to be immune from the effects of globalization, applied technology and changing consumer demands. This is unquestionably true for financial services. Perhaps the most convincing evidence is the flood of media stories reported almost daily on the dramatic changes taking place in the sector both in Canada and abroad.

How these forces of change will affect Canadians and shape our financial sector is not at all clear. Some argue that globalization of financial services markets offers the promise of better-quality service and greater choice. Others argue that both the pace and magnitude of change raise serious questions about the impact of these forces on the safety and soundness of the financial system. At an individual level, many Canadians are concerned about the impact that industry reaction to these forces of change will have on the cost, quality and choice of financial services.

The financial services sector is fundamentally different from other sectors of the economy. Financial services are essential to the everyday lives of Canadians, and a well-functioning financial system is critical to the commercial economy and an important contributor to economic growth and job creation. Canadians

[1] James D. Wolfensohn, "Remarks at the Council of Foundations Luncheon," Washington, D.C., April 28, 1998, p. 3.

entrust their wealth to financial institutions, often with little knowledge of the underlying risks of their investments but with confidence that the institutions will honour their promises to pay and meet their obligations to depositors and policy holders. Canadians expect much of their financial institutions and demand from them higher standards of conduct than from most other corporations.

Market forces are insufficient to ensure that financial institutions meet the standards against which they are judged. Financial sector regulation is essential to achieve minimum public policy objectives, even though it may affect the ability of institutions to pursue competitive business strategies completely unfettered.

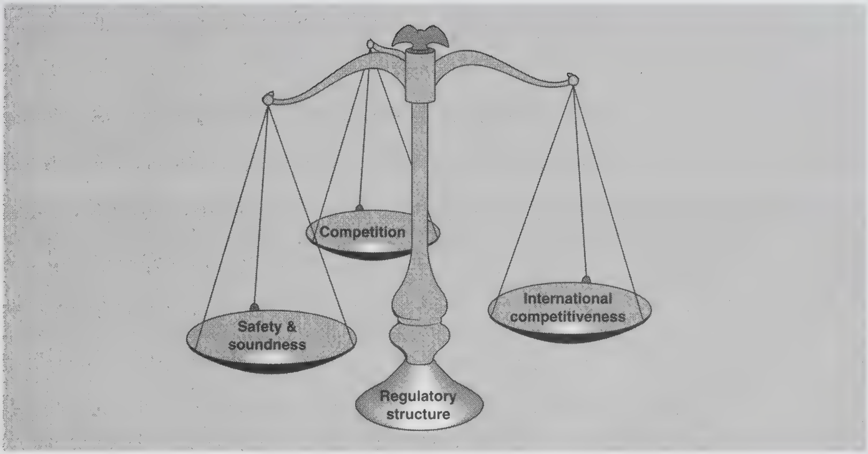
Some of the policy concerns which drive regulation include:

- ***Prudential risk.*** Financial sector regulation seeks to ensure that the financial system is not unduly exposed to destabilizing risks and that the financial institutions that make up the system are generally sound.
- ***Market conduct.*** Financial sector regulation seeks to protect consumers from inappropriate market behaviour and to provide consumers with adequate and timely information, protection of their privacy and opportunities for redress when they are not dealt with properly.
- ***Corporate conduct.*** Many laws of general application ensure that all businesses, including financial institutions, operate under the principles of good corporate conduct. An example of this is competition law, which seeks to ensure that no firm is able to exercise undue market power at the expense of competition.

The regulation of financial services effectively determines how potential trade-offs between competing objectives are resolved. For example, regulation that is intended to accomplish certain public policy objectives regarding safety and soundness may ultimately limit the attainment of another objective, such as competition. Similarly, there may be trade-offs between allowing domestically based financial institutions to become internationally competitive and maintaining an acceptable degree of domestic competition (see Exhibit 1.1).

In financial sector regulation, the choice of regulatory structure affects both the extent to which there are trade-offs between these objectives and how the balance between them is resolved. The challenge for governments on behalf of all Canadians is to find the right balance between these competing objectives while striving for a choice of structure that minimizes the trade-offs between them. In a sector that will continue to experience rapid change, this will be no easy task.

Exhibit 1.1
Regulatory Trade-offs



This paper is the first of five background papers. It provides an overview of the environment in which the Task Force is addressing financial sector issues. The paper:

- provides a description of the forces driving change in the financial services sector and their impact on the international and domestic markets; and
- offers an overview of the financial services sector in Canada at the present time.

The paper then addresses the key issues associated with the potential trade-offs between the objectives of competition, international competitiveness and safety and soundness. Specifically, the paper:

- reviews the present state of domestic competition in financial services and identifies ways in which competition can be enhanced to improve choice, quality and prices for Canadians;
- explores the topic of international competitiveness with a view to understanding the opportunities and challenges for Canadians and their financial institutions presented by an increasingly globalized world;
- assesses the merger review policy and process in Canada in light of the changes taking place in international and domestic markets; and
- examines the question of Canadian control of our financial system.

This paper addresses some of the key issues and their implications in detail. For other issues, the discussion in the paper serves as a beginning point to a more comprehensive analysis contained in one of the other four background papers.

Chapter 2

The Forces of Change

Globalization, technological advances, demography and economic change are forces that are driving innovation and giving rise to new opportunities and demands in the Canadian financial services sector. These forces will have a dramatic effect on the nature of financial services and the structure of the sector over the next decade and beyond. Financial sector policy will be ineffective if conceived without regard to these powerful forces.

This chapter will outline the nature of the forces of change and discuss their impact on consumers of financial services, providers of those services and governments.

The Forces

Globalization

National markets around the world are becoming increasingly integrated. The spread of market economies, the breakdown of trade barriers, the availability of low-cost, fast transportation and, of course, the dramatic impact of applied technology are all responsible for placing the farthest corners of the world within easy reach. As a result, businesses have access to more customers and face new, fierce competition. Consumers enjoy greater choice from more competitors. Consider the bookseller in Nova Scotia who puts a listing of his collection on the World Wide Web and suddenly the majority of his sales are offshore. A student sitting in front of a computer in Vancouver pays for and downloads the latest version of a program from a German software company. Globalization is not the wave of the future; it is real and it is happening now.

For competitive firms that embrace the trend, globalization represents a tremendous growth opportunity. In fact, the differing rates at which countries around the world are developing means that firms facing a mature product or service market in one country will potentially find vast emerging markets offering better growth opportunities in another. The growth of the markets of developing countries, along with their integration into the global economy, is a key element of globalization. These countries are characterized by dynamic and rapidly evolving financial markets. For instance:

- Their economies are more volatile. The real growth of developing economies over the last 10 years, at almost 6 percent, has been twice that of mature industrial economies, with consequences for the development of financial markets. Economic growth has supported the emergence of a middle class in these countries, with an associated market for financial services.
- While incomes are still lower than in industrial countries, savings and investment rates in many cases are higher. For example, throughout the 1990s, savings rates in some Asian countries exceeded 30 percent, whereas in industrial countries they were near 20 percent. Such savings must be intermediated through financial markets to reach borrowers and issuers.
- In developed countries, many financial products and services have matured and face limited prospects for market expansion. These products and services (such as life insurance) have good growth prospects in developing countries. This encourages the transfer and adaptation of product concepts.
- Historically, unreliable communications, inadequate legal and regulatory frameworks, and erratic monetary and fiscal policies dogged by periodic bouts of inflation inhibited the development of financial markets in developing countries. Over the last two decades, there has been an improvement in these enabling factors, which has facilitated the integration of the financial markets of these countries into the world economy.
- The policies of developing countries have also become more outward-looking. External capital controls are being dismantled, freely convertible currencies are now fairly widespread, and the governments of many developing countries have moved from inward-looking economic policies several decades ago to the promotion of trade and foreign investment.[2]

A truly global market for goods and services is emerging in some sectors. The global firm is able to develop, manufacture and market new products over a vast scale, which means that development and fixed costs can be amortized over more units of output. Automobile manufacturing, pharmaceuticals, communications and financial services are no longer looked upon as comprising a collection of regionally distinct markets. The result is the emergence of huge, world-scale competitors that, in some cases, exceed in size the economies of small countries.

Globalization is not just about the mobility of producers of goods and services; it is also about the mobility of customers. Consumers who realize they are not confined to the constraints of geography in making their purchases are able to expand their own markets. In the 1980s, Canadian companies and, indeed, governments discovered that they were a phone call away from the largest

[2] International Monetary Fund, *World Economic Outlook*, 1997.

market for wholesale financial services in the world. Laws may be able to keep a foreign competitor out of a country, but they cannot keep the customer from seeking out the best deal available even if that is outside the country. Globalization represents empowerment for consumers.

Globalization will not always follow a smooth path. As national economies become intertwined, the ability of an economic crisis to spread between jurisdictions increases. The instability of the Asian market, the impact of the resulting Pacific Rim banking and economic crises, and recent instability in Russia are graphic reminders of the serious risks that still face emerging economies and the way in which economic shocks can be widely and quickly transmitted in a global economy. The risks arising from globalization are not always apparent in advance of a crisis.

Although some markets are clearly more advanced than others, there is still a long way to go before all markets become fully integrated at an international level across all jurisdictions. However, the opportunities and challenges for firms, particularly in financial services, exist now. Public policy needs to embrace this change. This includes ensuring that Canadian firms have the same opportunities to exploit international markets as their international counterparts, that foreign firms are given greater access to Canadian markets for the benefit of Canadians, and that our regulatory structure in financial services is adequate to confront the problems that arise from the increased risks of globalization.

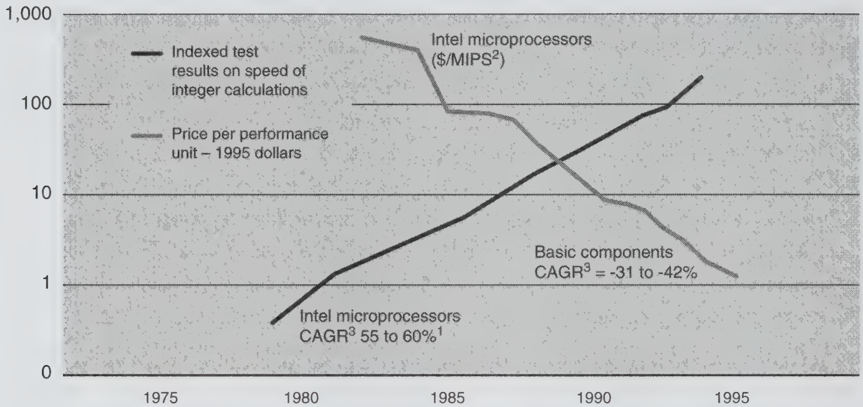
Technology

Another significant catalyst of change in financial services has been technology. Technology has the ability to further improve the speed, security, volume and quality of financial information-processing, and continues to greatly lower the unit cost of transactions. Since 1982, the cost of a microprocessor with a computing capacity of one million instructions per second has fallen from almost $1,000 to $1.30; within a decade, it is expected to cost about a tenth of one cent (see Exhibit 2.1).[3] The impact of being able to double the processing power of the microprocessor roughly every two years combined with an exponential decline in cost is difficult to grasp. To put this change in some perspective, Morley Winograd, a vice-president at AT&T, explained in a speech in late 1996 that had this progress been applied to the automotive industry, a luxury car would cost about $2, would travel at the speed of sound and would consume only a thimbleful of gas every 1,000 kilometres.[4]

[3] McKinsey & Company, *The Changing Landscape for Canadian Financial Services: New Forces, New Competitors, New Choices,* Research Paper Prepared for the Task Force on the Future of the Canadian Financial Services Sector (Ottawa, September 1998), p. 24.

[4] Morley Winograd, "A Social Contract for the Information Age: Future Presidential Campaign" (Los Angeles, November 1996), pp. 1, 2.

Exhibit 2.1
Microprocessor Performance and Costs



[1] 50% due to microprocessor and 5–10% due to compiler improvements.

[2] Million instructions per second.

[3] CAGR = compound annual growth rate.

Sources: McKinsey & Company Global Forces Initiative; "RISC vs. CISC," *Microprocessor Report*, January 23, 1995; "Systems Performance," *Dataquest*, 1993; "Rigid Disk Storage," *Dataquest*, 1994; *DRAM Memory*, Bernstein Research, 1980–93; *Dataquest*, 1994–95.

Financial services are information-intensive businesses.[5] As a result, the exponential increase in computing power and the decrease in costs are having a profound and irreversible effect on this sector. Technology makes possible financial products and services that were generally unheard of only a few years ago, such as index-linked term deposits, point-of-sale payment terminals, complex derivatives, and the optical security device on bank notes. Paper securities have been immobilized or phased out, and stock and bond trading is conducted mostly on an electronic book; stock exchanges are closing trading floors in favour of computer-based order entry and execution; and systems such as Mondex – which allows users to store electronic cash on a single card – are altering our basic understanding of money.

Emerging communications technologies make it possible to deliver financial products and services at low cost to even the most remote corners of our country. As computing and communications technologies converge, individuals will be able to have real-time access to financial services anywhere, at any time. The implications of this are profound. Concepts such as a deposit or withdrawal

[5] It is worth noting that technological change in the economic sense does not necessarily mean high-tech computing; it can mean more efficient ways of doing things, rendered economic by cost reductions.

will lose meaning. Will it make sense to "withdraw" cash when we have real-time access to our funds electronically at a lower cost than coins and bills? What is the need for a debit or credit card when your purchase card will automatically allocate the cost of a purchase to the appropriate account depending on your economic profile? The concept of banking is changing and, for a new generation of Canadian consumers, the world of financial services will bear little resemblance to the business that we have come to understand.

Canadians appear to be openly embracing new technology. Over the past 10 years, the number of households with home computers has more than tripled. Statistics Canada reports households with home computers climbing from 10 percent in 1986 to over 36 percent last year.[6] More recent studies by Ekos Research Associates and A.C. Nielsen put the percentage of Canadian households with a computer at over one half.[7] Since households with more than one person are more likely to have computers,[8] this number probably understates the actual percentage of Canadians with access to computers in their homes. Thirty-seven percent of Canadians also report having used the Internet in the last three months, and 28 percent indicate they have access to it from their home.[9]

Our appetite for convenience and ease of access puts Canadians among the fastest adopters of new financial services technologies, such as automated teller machines (ATMs) and debit cards. Exhibit 2.2 shows the recent growth of direct payment transactions over Interac, the system used to exchange ATM and debit card transaction information between financial institutions. From 1988 to 1995, the volume of paperless payment instruments (i.e., other than cash and cheques) grew at an average yearly rate of 13.9 percent, while chequing transactions fell by an average of 1.49 percent annually.[10]

Just as applied technology can substantially enhance customer convenience and choice, it can also provide tremendous opportunities to address many of the public policy issues in ways not previously conceived of. Creative applications of lower-cost technology continue to be directed toward challenges such as access to financial services from remote locations, the development of low-cost products to reach underserved markets, and lowering the risks (and hence costs)

6 McKinsey, *The Changing Landscape for Canadian Financial Services,* p. 24; Statistics Canada, 1997 Household Facilities and Equipment Survey as reported in *The Daily*, (Ottawa: Statistics Canada, March 20, 1998).

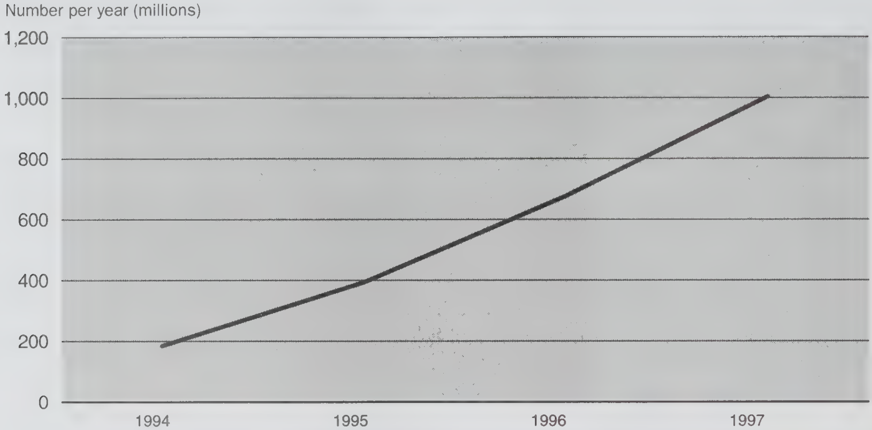
7 Ekos Research Associates, *Information Highway and the Canadian Communications Household: Overview of Findings* (Ottawa, February 1998), p. 2. A.C. Nielsen, "Canadians Embrace Technology for Business and Pleasure," news release (Markham, Ont., March 4, 1998).

8 Statistics Canada, Household Facilities and Equipment Survey in *The Daily*.

9 Ekos Research, *Information Highway*, p. 2.

10 Bank for International Settlements, *Payments Systems in the Group of Ten Countries* (Basle, 1993) and *Statistics on Payment Systems in the Group of Ten Countries* (Basle, 1996).

Exhibit 2.2
Number of Interac Direct Payment Transactions



Source: Interac.

arising from government payments. Efforts can also be directed at improving the user-friendliness of applied technologies in financial services to ensure that the most reluctant of users are able to embrace and thereby enjoy the many benefits of technology.[11]

Although the costs of underlying technology are dropping, the task of developing new technologies and updating existing ones[12] can be very costly. Statements such as the "high cost of technology" usually refer to the cost of developing the applications which use the technology, as opposed to the cost of the underlying technology. If an application of technology is employed broadly, the fixed development cost will be spread over a larger revenue-cost base, thereby reducing its impact on a per unit basis. However, many applications of technology display a "networking" characteristic whereby the success of the technology is dependent on a critical mass of users accepting it.[13] Exhibit 2.3 uses the growth in point-of-sale debit card transactions cleared through the

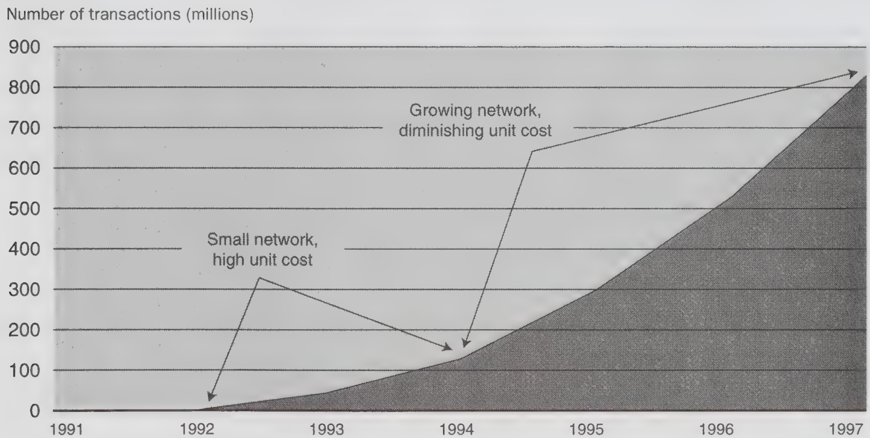
[11] Telephones, televisions, microwave ovens, etc., are examples of technologies which, with time, have gained greater mainstream user acceptance. The same is occurring with technologies in financial services (e.g., debit cards).

[12] Expenditures on dealing with the "Year 2000" problem offer one example of the cost associated with updating existing technologies to ensure their continued performance. Efforts by deposit-taking institutions to integrate their customer files across different parts of the operation (e.g., lending, brokerage, mutual funds) has been a costly updating exercise.

[13] The importance of compatibility of technologies gives rise to the networking phenomenon. Consider the fax machine. It provides little value to the user unless others employ the same technology. Many technologies in financial services have displayed this networking characteristic, such as ATM machines and direct debit cards.

Canadian payments system to illustrate the familiar growth pattern of network technology. The development of a technology application often involves considerable up-front costs, is not likely to produce reasonable returns at the initial stages of usage, and may never prove profitable if a critical mass of users is not achieved. The importance of common standards to gain widespread acceptance and the high, up-front costs of development are reasons why financial institutions, like other industries, often work together to establish common technology platforms upon which individual firms can compete. Examples include the Canadian payments system, Interac and the new Mondex cash card pilot project.

Exhibit 2.3
Growth of Electronic Funds Transfer at Point of Sale



Source: Canadian Payments Association.

Domestic Demographic Changes

Demographic trends in Canada are also shaping our financial services sector.

The most widely discussed demographic trend – the ageing of the "baby boomer" population[14] – has had a visible impact on the evolution of the financial services marketplace. Some 9.8 million Canadians, or about one third of our population, dominate the market for retail financial services. They contributed to the strong growth of mortgages through the 1970s and 1980s, and are now the main focus of retirement products for drawdown in the next century.

14 Baby boomers include those Canadians born between 1947 and 1965.

The boomer population will soon inherit an unprecedented amount of wealth from their parents. One estimate is that $1 trillion of wealth will transfer between generations.[15]

The ageing population puts tremendous pressure on Canada's social safety net in such areas as health and public pensions. Canadians are less optimistic about their ability to rely on governments for their financial, health and retirement needs. This has implications for the role of the financial sector in helping Canadians meet their needs in such areas as retirement financing and supplementary health coverage. The governments' response to these pressures can also have significant market implications. For example, proposed changes to the funding of the Canada Pension Plan (CPP) will unleash a pool of capital in domestic securities markets.[16]

Trends in employment, driven in part by demographics, are also affecting the environment for financial services. The substantial increase in female participation in the labour markets throughout the 1970s and 1980s has led to a growth in dual-income households. A large part of this growth has been in part-time jobs. Self-employment represents 17.9 percent of Canada's total employment in 1997, up from 13.3 percent in 1986.[17] Eleven percent of employed Canadians report that they work primarily from their home. Almost half of working Canadians (48 percent) say they work out of their home regularly or some of the time. Moreover, a strong majority of Canadians believe they will be working more of the time from their homes.[18]

Since jobs in small business and self-employment tend not to be covered by group pension and insurance benefits plans, this group needs customized individual life and health insurance and retirement planning services. Self-employment and work-at-home trends also change the nature of commuter patterns (e.g., less travel to core urban centres) and create new needs in terms of the convenience and ease of access to financial services.

15 LOMA, *Demographics in the 1990s and the Life Insurance Industry* (Canadian edition), 1992, p. 45.

16 Federal and provincial governments announced on February 14, 1997, their intention to allow new inflows of funds to the CPP to be invested in a diversified portfolio of securities by an independent investment board, subject to broadly the same investment rules as other pension funds. The 20 percent foreign property rule will apply. Legislation giving effect to this new policy was passed into law in December 1997. The current reserve fund is expected to grow from about two years of CPP benefits (about $40 billion) to over four years of benefits over the next two decades. At the end of 10 years, the CPP fund is projected to be about $100 billion, of which up to $75 billion would be managed by the investment board. The CPP fund will be among the largest investment funds in Canada, comparable in size to the Ontario Teachers Pension Plan and the Caisse de dépot et placement du Québec. By way of comparison, Canadians held about $280 billion in mutual funds at the end of 1997.

17 *Collective Reflection on the Changing Workplace*, Report of the Advisory Committee on the Changing Workplace, Human Resources Development Canada (Ottawa, June 1997), p. 9.

18 Ekos Research, *Information Highway*, pp. 5, 6.

Another trend has been the migration of people away from many rural locations. This has implications for how financial institutions maintain national pricing policies and ensure adequate access to financial services in smaller, depopulating communities.

Although the baby boomer phenomenon is clearly a powerful predictor of changing consumer demand, it is certainly not the only one. The multiple dynamics of demographic change pose both immediate and indirect challenges for the financial services sector and policy makers alike. Ongoing shifts in demographics will continue to build new market opportunities, shape demand and influence suppliers of financial services in ways not previously encountered.

Economic Change

Certain features of the current economic environment have implications for the behaviour of financial institutions and markets. One has been the sea change in inflation rates. A low rate of inflation affects expected yields and consumer investment preferences. Lower interest rates in recent years, the result of lower inflation, have prompted investors to look beyond deposits and government bonds to enhance returns. This has been a factor in the explosive growth of mutual funds.

Another major economic change is the emerging move into budgetary surplus on the part of Canadian governments. Other things being equal, this will contribute to higher national savings and greater export of capital. As Canadian investors accumulate claims on non-residents, their focus and attention will become more outward-looking. Within Canada, the gradual reduction of government debt will be reflected in a restructuring of portfolios, with increased emphasis on private-sector debt.

Impact of the Forces of Change

The impacts of these changes on consumers of financial services, the institutions that provide them and governments are profound and will continue to drive the unrelenting pace of evolution in financial services for the foreseeable future.

Consumers

Technology and globalization have clearly left their mark on the wholesale market for financial services. Banking centres such as London, New York and Tokyo service corporate clients around the world at prices and service levels determined by intense global competition. Large Canadian companies have

ready access to these international capital markets, and much of their capital and financing is raised through large multinational firms.[19]

With access to international, competitively priced wholesale banking services, large Canadian companies have become sophisticated consumers of financial services. They tend to spread their banking business across several banks. In a survey conducted by The Conference Board of Canada for the Task Force, only 5 percent of chief financial officers (CFOs) of large Canadian companies indicated that they restrict their banking relationships to one bank.[20] Two thirds of the companies surveyed did at least some of their banking with a Schedule II bank.[21]

The impact of globalization will continue to spill over into the retail financial services market, as technology makes its impact on the delivery systems for this segment. Not only will financial institutions find ways to enter the Canadian financial services market using lower-cost channels – such as ING, a subsidiary of a large Netherlands insurance and banking conglomerate which has launched an electronic banking service in Canada – but other institutions will encourage customers to seek services outside the country. For example, Wells Fargo, a U.S. bank, offers loans to Canadian small business by mail but has no physical presence in Canada.

Consumer demand for retail financial services has shifted considerably in recent years in response to the forces of change. Retail consumers have changed their overall consumption patterns, the mix of their financial assets and liabilities, and the manner in which they access financial services. The shift in retail consumer demand is quite visible in the household balance sheets of Canadians:

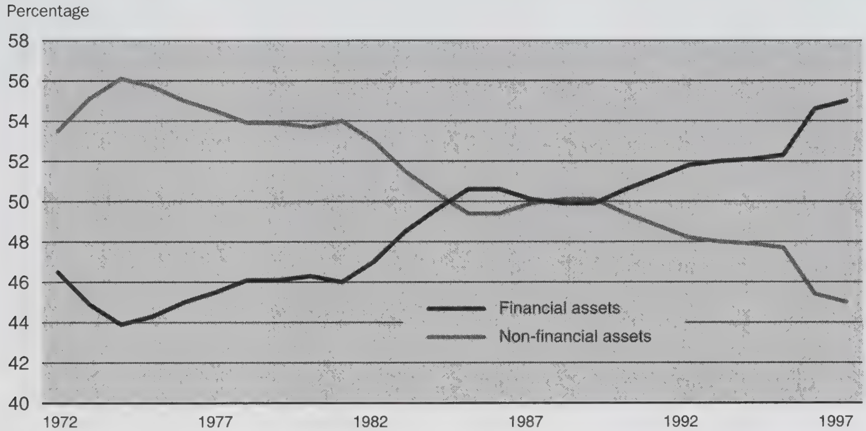
- There continues to be a movement from real assets (such as houses, cars and household goods) to financial assets (deposits, investments, insurance products). See Exhibit 2.4.
- There also has been a shift among the types of financial assets held by Canadians. See Exhibit 2.5.
- While total deposits retain an important place among household financial assets, their growth relative to overall assets has been stagnant and is expected to decline over time. See Exhibit 2.6.

[19] CFOs of large Canadian companies indicated they generally saw Canadian banks as "largely non-players" in credit and funding products outside of Canada. Hugh Williams, The Conference Board of Canada, *Corporate Banking Relationships in Canada: The CFO View,* Research Paper Prepared for the Task Force, (Ottawa, September 1998), p. 11.

[20] Ibid., p. 9.

[21] Ibid., p. 10.

Exhibit 2.4
Total Household Assets



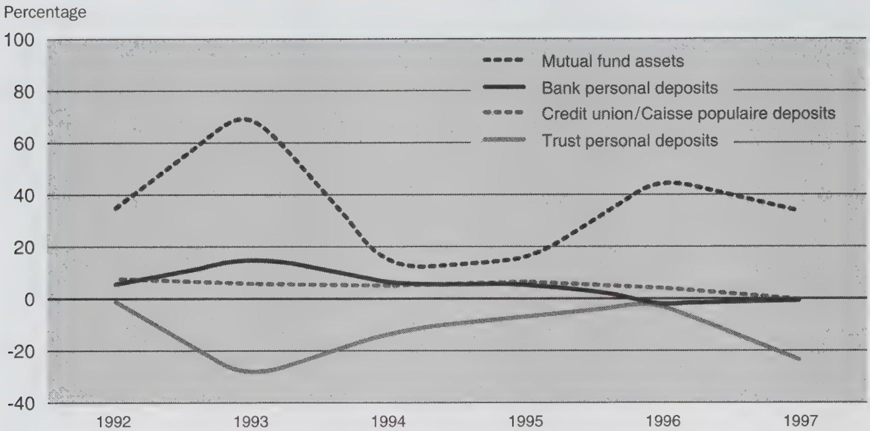
Source: Statistics Canada National Balance Sheet Accounts.

Exhibit 2.5
Household Financial Assets
(percentage of total household financial assets)

	1977	1982	1987	1992	1997
Mutual funds	1.0	0.9	3.0	5.2	14.2
Pension claims	9.6	12.4	15.4	17.6	21.6
Shares	19.6	22.1	20.8	16.7	14.2
Bonds and money market instruments	11.1	10.5	10.9	8.0	5.3
Deposits	31.0	34.1	30.0	32.5	25.1
Life insurance	10.5	10.0	10.6	11.4	10.7
Other	17.2	10.0	9.3	8.6	8.9

Sources: Statistics Canada National Balance Sheet Accounts, Bank of Canada.

Exhibit 2.6
Annual Growth Rates



Sources: *Bank of Canada Review*, Investment Funds Institute of Canada.

- Direct holdings of securities have declined, but this drop has been more than offset by growth in holdings of pooled and mutual funds. This appears to be in response to the economics of pooled investments.
- The extent to which managed and pooled funds have taken market share from traditional intermediated savings (e.g., deposits) represents an increase in both the term of retail investment and the risk tolerance of consumers.
- The emphasis on longer-term savings products has propelled the demand for financial planning and wealth management in the 1990s.
- On the liability side, lower growth in family formation and the shift from real to financial assets means relatively less demand for new housing and consequently less mortgage and consumer credit financing.

These trends in household balance sheet items are expected to continue into the next century. [22]

An ageing population has significant implications for the financial services industry. Life insurance will probably experience slow growth, since more than 80 percent of new policies sold in Canada have traditionally been sold to those under 35 years of age.[23] However, an ageing population will have a greater need for retirement products and supplementary health insurance coverage.

22 Earl Bederman, *The Outlook for Retail Financial Services in Canada: The Next Decade*, 3rd edition (Toronto: Investor Economics, December 1996), pp. 99, 127.

23 LIMRA, *Trends in Canadian Insurance* (Hartford, 1997), p. 29.

The transfer of wealth between generations over the next decade will provide increasing opportunities in the areas of financial advice and asset management. This will put upward pressure on the demand for longer-term and riskier investment products, amplifying the trends noted above.

A changing work force also creates opportunities for financial services. An increase in self-employment and in the number of people working out of their homes limits the opportunity to market financial services through employers (e.g., pension benefits, health benefits plans and financial services affinity programs). However, the same trend represents a new opportunity to target these services directly to individuals working in the home, who are likely to put a premium on convenience and to be open to new technologies.

Another implication of the demand for convenience is the tendency for consumers to rely on familiar products and services with good reputations and track records as a means of reducing their search time.[24] This has enormous implications for how institutions market and brand their services. The importance of minimizing search time is also leading to the emergence of new competitors in financial services. For example, Internet integrators such as Intuit and I|Money are making it easier for users to compare prices and features between service providers (see Exhibit 2.7). The emerging generation of technology promises "intelligent-agent" software which will seek out services based on predefined customer preferences (e.g., risk profile) and complete transactions with little interaction on the part of the customer. These trends point to a potential breed of technology-based competitors that will offer new value propositions to consumers at the same time as they raise new challenges for existing institutions and governments.

Industry

Change in the Canadian financial sector in response to domestic and international forces has been dramatic. Markets are placing relentless pressure on publicly traded companies to grow in a manner that consistently improves shareholder value. This has implications for financial institutions, particularly those that are capital-intensive, such as deposit-taking institutions and publicly traded insurance companies. There is constant market pressure to grow in areas where returns are greatest and to shed businesses where returns are substandard. For publicly traded financial institutions, markets force management to continually focus on making costs more efficient and to find ways of growing their non-capital-intensive businesses. In fact, much of the recent profitability of larger financial institutions is derived from businesses in which they were not players more than 10 years ago.[25]

24 McKinsey, *The Changing Landscape*, p. 25.

25 See, for example, Exhibit 3.8 in Chapter 3, which shows the recent growth of non-traditional income by deposit-taking institutions.

Exhibit 2.7

Financial Services Integrators and Intelligent-Agent Software

Historically, the manner in which financial services were sold was largely governed by institutional structure. For example, one went to a branch for banking services, life insurance was sold by life agents, car and automobile insurance was available through a broker, and investments in securities were made through securities dealers. The changes sweeping through the financial services sector are casting these distribution paradigms aside. The use of automated tellers, the Internet, 1-800 numbers and direct sales channels are just a few examples of the new types of distribution methods that are redefining financial services distribution.

The use of sales intermediaries, such as insurance, deposit and mortgage brokers, to distribute financial services is certainly not new. However, a new breed of intermediary – the information integrator – is emerging and has the potential to dramatically change the way we purchase financial services. Using the power of new electronic delivery channels such as the Internet, an information integrator provides a common access point or gateway to various information-based services. The distinctive strength of information integrators is their ability to bring together, or "integrate," information on a range of services from many suppliers in one place, saving consumers the cost of seeking out and comparing the information from various suppliers. For example, an integrator may take information about one's insurance needs and provide a range of quotes from different insurance companies for the type of coverage required.

Although information integration of this nature is only beginning to mature on the Internet, problems in electronic intermediation parallel the physical world. For example, there is the key question of how to price for such a service. Should the integrator charge the customer for the integration service, as does a fee-based financial planner, or the supplier of the financial service, as does an insurance broker? Or does the low cost of setting up an integration service mean that the integrator should look to new forms of revenues to support the business model, such as advertising? In the nascent market of information integration, it is not surprising to find a number of firms testing a variety of models.[1]

Are integrators the next big players to dominate financial services? Probably not. The costs of setting up an integrator are low and hence there are few barriers to entry. There are certainly many companies attempting to find the right information integration model in financial services and elsewhere. In addition to strong competition, a new breed of software – "intelligent" agents – threatens to displace the current stable of integrators. The intelligent agent is a software-based tool which collects, filters and presents information in a customized fashion for users. For example, intelligent-agent software can be set up to identify excess funds in a chequing account, select among competing savings vehicles based on the user's risk and pricing preferences, and then transfer the funds to the appropriate

Exhibit 2.7 (continued)

investment, all without the user's necessarily being aware of the transaction. The ability of intelligent-agent software to not only gather and compare information, like the information integrator, but to make decisions based on the information is likely to diminish the value of the more limited role of information integrators.

Financial service suppliers such as banks and insurance companies have good reason to be concerned about the impact of these electronic integrators and intelligent agents on their businesses. Through the intermediary function, integrators and developers of intelligent agents are well positioned to develop strong trust-based relationships directly with consumers. Financial institutions risk being relegated to wholesale suppliers of commodity financial services. Like the food products company competing for shelf space in grocery stores, financial services providers may need to focus on brand marketing to gain customer attention and retain market share. Alternatively, they may choose to expand into the integration role and intelligent agent market, pre-empting a potential loss of control over customers. However, doing this may prove challenging in light of the inherent conflict between acting as an objective multi-brand vendor and an exclusive brand producer.

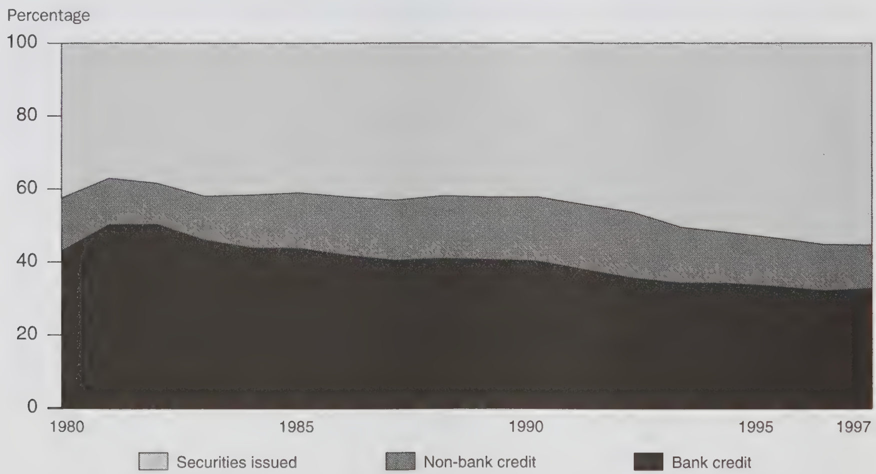
Most significant, this trend means that producers of financial services will need to become more transparent in their disclosure of product information in a manner that allows for easy and favourable comparison with other competitors. The alternative is to be excluded from information integration services altogether. This trend will gradually reduce the information asymmetries which exist between producers of financial services and users, and thereby improve overall competition. (See the section on information asymmetries discussed in Chapter 5.)

[1] The following sites offer integration services of a varying nature: Quicken in the United States (www.quicken.com) allows users to compare quotes on insurance, mortgages and many banking products; IIMoney (www.imoney.com), a Canadian company, allows users to shop on-line for a range of financial products including mortgages, insurance, credit cards, etc. from competing providers; Industry Canada (strategis.ic.gc.ca) provides an on-line service which allows users to compare credit card costs and bank account service fees based on typical product usage for different deposit-taking institutions; E-Line Financials (www.financials.com) compares prices for on-line discount brokers and provides links to compare on-line banking services in the United States and Canada; the Fund Library (www.fundlibrary.com) and Globe Fund from Global Information Services (www.globefund.com) allow investors to compare performance and other features of mutual funds offered in Canada; InsuranceQuote.net (www.insurancequote.net) is a starting point for locating on-line quotation services for all types of insurance in the United States and, eventually, in Canada.

1. Wholesale Financial Services

In wholesale financial services, the forces of change are having a visible impact on the nature of competition in Canada. Markets for corporate banking services, such as equity financing, cash management and financial risk management, are much more internationally integrated. Growing customer sophistication about these types of services has further fuelled strong competition in this market. Corporate funding is a good example of the impact that globalization and customer sophistication have had on the demand for wholesale banking services. The portion of business funding derived from bank loans reached a peak of over 50 percent in 1982-83 and has since declined to less than one third (see Exhibit 2.8). Corporate customers have turned to lower-cost capital markets and asset-backed finance firms for their funding needs. This trend was a key driving factor in the decision of banks to enter the securities underwriting business in the mid-1980s.

Exhibit 2.8
Shares of Business Financing Market



Source: *Bank of Canada Review.*

The impact of globalization is beginning to show up in the names of competitors making up the Canadian financial landscape. Firms such as State Street and Northern Trust (securities custody), Newcourt Credit Group and GE Capital (asset-backed financing), Automated Data Processing Inc. and Ceridian (payroll processing), and Countrywide Credit Industries (mortgage origination) are looking at making their presence felt not in the full range of traditional, mainstream

businesses of banking but rather in select markets in which they have a competitive advantage. For example, in only a matter of years, international giants have come to dominate the Canadian securities custody and payroll markets.[26] Similar "category killers" are beginning to emerge on the retail side and are expected to make significant inroads into the Canadian market. Examples include U.S.-based companies such as MBNA, a direct marketer of credit cards, and Countrywide, a mortgage originator.

2. Retail Financial Services

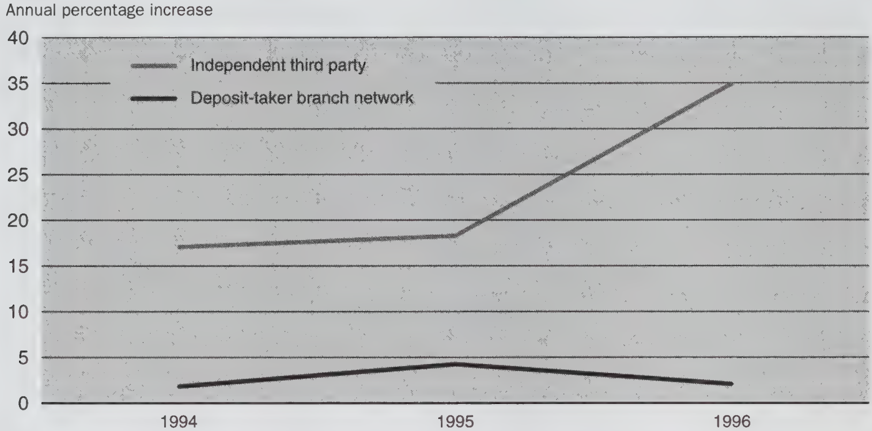
In retail financial services, competition for a place on the household balance sheet is strong, particularly with respect to discretionary savings. New entrants are focussing on changing customer needs to gain market share. Financial planners are capitalizing on the increased complexity of investment products and the need for advice to develop customer bases. Life insurance agents and stockbrokers are also emphasizing the advice component of their services as a means of establishing stronger relationships with their customers. Meanwhile, discount brokers and mutual fund companies are focussing on the self-help investor, who is less interested in advice and more concerned with lower prices and convenience. Traditional financial institutions are being forced to either change in order to compete with these lower-cost and focussed competitors or ultimately face erosion of their market share.

3. Distribution Channels

The challenge for traditional players lies not only in developing new products but also in competing against new distribution channels. New players are often able to enter markets using lower-cost distribution channels, such as telephone and electronic sales. For existing firms, this creates the challenge of reconciling the need to meet the demand for new distribution channels while maintaining traditional, higher-cost channels, such as branch and agency networks. Although the costs of communication and information-processing services have gone down tremendously, the costs of traditional delivery channels, such as banking branch services and in-person advice-based services, remain relatively high. (Exhibit 2.9 contrasts the growth rates of assets managed by the independent, third-party distribution channel with the growth rate of deposit-taking branches.)

[26] State Street, a Boston-based bank holding company with more than US$3 trillion in assets under administration, is the largest mutual fund custodian in Canada, the United States and Australia. Northern Trust Company, a wholly owned subsidiary of Chicago-based Northern Trust, has trust assets under administration totalling $1.1 trillion and is a major player in the Canadian market. Minneapolis-based Ceridian is Canada's largest payroll company and is the second-largest payroll company in the United States. It recently completed the purchase of the payroll divisions of both the Canadian Imperial Bank of Commerce and Toronto-Dominion Bank, and now controls about 46 percent of the contracted-out payroll business in Canada. ADP of Roseland, New Jersey, is Canada's second largest payroll company, having just acquired the payroll businesses of the Royal Bank of Canada, the Bank of Montreal and the Bank of Nova Scotia. Today ADP processes the paycheques of over 21 million employees in North America and 2 million in Europe.

Exhibit 2.9
Growth in Household Discretionary Financial Assets by Distribution Channel



Source: Investor Economics Inc.

Maintaining a more costly distribution structure for a shrinking market share is pushing traditional financial institutions to either rationalize their costs or seek new ways of achieving cost efficiencies in the traditional channels. The extent of change in financial services suggests that survival for traditional players very much depends on choosing the right strategy and that success often requires making very challenging decisions with respect to traditional channels.

4. Technology

Technology is a key to innovation in both financial products and distribution methods. As a result, the forces of change have pushed the technology budgets of financial institutions skyward to the point that, in the case of many financial institutions, they are one of the largest single expenditures. Leading international financial institutions are each spending well over US$1 billion annually on technology; the budgets of some, such as Citicorp and Chase Manhattan, are estimated at close to US$2 billion.

The challenge of keeping up with new technology is forcing financial institutions to carefully examine whether it makes sense to perform certain technology-intensive functions in-house or to outsource. In fact, financial institutions are breaking down various aspects of their operations into more discrete components with a view to assessing which could be conducted outside the firm

more cost-effectively.[27] Examples of this kind of thinking are found in two separate transactions in 1996, in which the largest banks entered into joint ventures to carry out several of their non-competitive, back-office functions on a pooled basis.[28] In some cases, the cost of applying technology to remain competitive has been so pervasive as to force financial institutions to drop entire lines of business in which they felt they were unable to compete.[29]

Choosing to stay on the leading edge of technology through in-house development may be a valid strategy for success in financial services, but it is by no means the only one. For example, purchasing turnkey technology solutions is a viable strategy. Royal Bank of Canada purchased technology, software, systems and advisory support from a company in the Co-operators Group to allow Royal to develop a property and casualty insurance operation for home and automobile insurance. A U.S. firm called Digital Insight specializes in providing smaller financial institutions (mainly credit unions) Web-based services, including on-line banking.[30] This enables smaller institutions to offer Web-based banking solutions for customers at a lower cost and on a competitive basis with larger institutions.

5. Financial Institution Positioning

The forces of change are compelling financial institutions to fundamentally re-assess their business strategies. The responses are varied. In some cases, financial institutions are repositioning their business to focus on key markets and capitalize on core strengths. This might include dropping or selling lines of business in which a financial institution has no real competitive advantage. In other cases, the institutions are looking to grow their market share in specific business lines or locations where they believe they do have a competitive advantage but may, for example, need sufficient scale to keep unit costs down to remain competitive.

As institutions reposition themselves to cope with the forces of change, transformations continue to take place at the organizational level. A firm which chooses to drop a line of business may sell some of its operations, as has happened

[27] A report by Deloitte & Touche LLP provides a good description of the international trend toward disaggregation in retail banking. See *The Future of Retail Banking: A Global Perspective*, 1995, beginning p. 25.

[28] Royal Bank, Bank of Montreal and Toronto-Dominion Bank set up Symcor for high-volume processing of cheques, customer statements, credit card sales, drafts and remittances. The Bank of Nova Scotia and CIBC set up a strategic alliance named Intria to combine certain back-office functions in network support, computing centres, end-user devices, ATM servicing and document processing. Brent Sutton, *The Canadian Financial Services Industry: The Year in Review, 1996 Edition* (Ottawa: The Conference Board of Canada, November 1996), p. 21.

[29] An example is the movement of banks away from payroll and global custody services, mentioned earlier.

[30] See Digital Insight at **www.diginsite.com.**

recently with the Canadian operations of several foreign insurance companies. Financial institutions may be encouraged to merge with competitors to achieve cost efficiencies such as by rationalizing an existing costly distribution channel. Similarly, mergers or acquisitions may be pursued in order to expand the scope of products that the financial institution is able to sell to its customers.

An extremely visible impact of institutional repositioning is the mergers and acquisitions wave which continues to ripple through the financial sector around the globe. International merger and acquisition activity in financial services has grown significantly over the last 15 years.[31] On the wholesale side, this has led to increased concentration of services in very large firms operating mainly in major world financial centres. Much of the first wave of mergers worldwide has been national in-pillar mergers (i.e., mergers among firms within the same industry and within the same national jurisdiction), and has largely been in response to overcapacity and to the need to achieve greater economies of scale. The majority of the major U.S. bank mergers have been in-pillar. Another type of merger is also becoming more common: combinations of institutions in different pillars, such as banking, securities and insurance. The recently announced merger between Citicorp and Travelers Group to form the world's largest financial conglomerate and the failed bid by Royal Bank for London Insurance Group last year are examples of this cross-pillar type of transaction. The third type of merger, likely to become more prominent in coming years, is major cross-border mergers. There have been some examples of mergers and acquisitions among European banks as their countries' economies become more intertwined. The merger announced between Daimler-Benz of Germany and Chrysler of the United States in the automotive industry is a better example of this type of cross-border transaction.

The merger and acquisition wave has clearly affected the Canadian financial services market. The acquisition of investment dealers in the mid-1980s – an example of cross-pillar mergers – resulted in a recapitalized domestic securities industry that was at risk of becoming increasingly marginalized or being bought by foreign firms. It also permitted banks to offer a broader range of financing services to corporate clients at a time when a large number of clients was abandoning corporate borrowing for financing in securities markets. And it permitted financial institutions to provide investment services to retail clients who were looking for new ways to invest their savings.

[31] Both the number and value of mergers has grown in the past 15 years, by 16.5 and 24.3 percent respectively. McKinsey, *The Changing Landscape*, p. 34.

The acquisition of trust companies by insurers and banks permitted these institutions to broaden their services to meet the increasing demand for wealth management services, and it prevented the failure of some major trust companies that had made bad investment decisions in the late 1980s. In the case of banks, these acquisitions were part of a longer-term process of consolidation of deposit-taking institutions that continued with last year's acquisition of National Trust by the Bank of Nova Scotia and the recently proposed mergers between Royal Bank of Canada and Bank of Montreal, and between the Canadian Imperial Bank of Commerce (CIBC) and Toronto-Dominion Bank (TD Bank). Meanwhile, the successful bid by Great-West Life for London Insurance Group, Canada Life's recently proposed purchase of Crown Life's business and the acquisition of the Canadian operations of Metropolitan Life Insurance by Mutual Life Assurance are examples of ongoing consolidation in the Canadian life insurance sector.

6. Employment

Market and economic forces are dramatically affecting employment in the financial services sector. Key among these forces of change is the application of technology. This permits financial institutions to perform many functions more quickly, more efficiently and at lower cost than identical tasks performed by a person.

Technology is not the only driver of change affecting employment. The relentless push for shareholder value and growing, intense competition on an international scale are forcing firms to seek efficiencies in their operations and to strategically reposition themselves to focus on competitive strengths. The resulting industry restructuring is clearly having an impact on the nature and level of employment in financial services. For example, employment in the Canadian regulated financial services sector, estimated at over half a million, has remained relatively constant over the last six years although overall employment in the economy rose.[32]

The forces of change are not only affecting employment levels, but they are changing the mix of skills and the nature of jobs in the financial sector. As in many other areas of the economy, the ability to operate and manage technology is becoming an increasingly important skill requirement, which is enhancing the quality of jobs and average compensation levels. For example, although financial institutions may be applying new technology to carry out transactions previously handled manually, there is a need for skilled people to design, implement and maintain the technology. Changes in consumer demand have prompted

[32] The employment numbers are derived from the Conference Board of Canada annual publication entitled, *The Canadian Financial Services Industry: The Year in Review* (Ottawa: The Conference Board of Canada) for selected years.

financial institutions to shift human resources away from transaction-based functions to higher value-added, advice-based channels. A report prepared by The Boston Consulting Group on financial services employment in the Greater Toronto area suggests that employees of financial institutions are better educated than the average work force, and that they are among the best paid.[33]

The impact of various forces of change on labour levels has unfortunate and serious social consequences, but the problems are not unique to the financial services sector. The underlying shift of the Canadian economy from a producer of primary resources and manufactured products to a service economy has transitional employment implications that are ongoing and widespread, affecting many sectors.

This paper examines the issue of employment in financial services in the next chapter and again in Chapter 7 in the context of mergers and the public interest.

7. Shape of Industry

We have only begun to witness the impact of the forces of change on the financial services sector. Eventually, distribution channels and financial services will change so significantly and will become so intertwined as to completely revolutionize the public's conception of financial services. As new entrants continue to reshape the markets, traditional financial institutions will accelerate their efforts to redefine themselves. What we now describe as banks, insurance companies, mutual fund companies, credit unions, securities dealers and so on may well be unrecognizable in as little as 10 years.

Government

Governments worldwide face a broad range of issues as they respond to these forces and the dramatic impacts they are having on the financial services industry.

At the national level, governments in the United Kingdom, Japan, Australia and the United States are reviewing and changing their legislative and regulatory framework for financial institutions. These changes are largely in response to the convergence in the types of services offered by different financial institutions and the emergence of new kinds of competitors. In Australia and the United Kingdom, for example, changes in the past year have re-aligned prudential supervisory powers for most financial institutions in one central office, as was done in Canada in 1987 for federally incorporated institutions.

Internationally, governments are also seeking to modernize regulation to deal with a world in which complex financial groups operate across national borders. Through cooperation in the Bank for International Settlements (BIS), the

[33] The Boston Consulting Group, *Financial Services at the Crossroads: The Current and Potential Role of Financial Services in the Greater Toronto Area* (January 1997), pp. 5-8.

Joint Forum (which brings together national regulators of banks, insurance companies and investment banks) and the Group of Seven (G-7), initiatives are under way to develop up-to-date principles for supervision and better surveillance mechanisms. The urgency has been heightened by crises of confidence in large parts of the world. In response to an initiative by the Canadian Minister of Finance, the G-7 is currently examining ways to enhance the framework for global surveillance of capital markets and financial institutions.[34]

In Canada as well, change is putting stress on the regulatory structure. The challenge to balance domestic competition, international competitiveness, and safety and soundness grows as the sector struggles to adapt to the forces of change. Trends such as an ageing consumer base, the growth of financial supermarkets in Canada, and the increasing emphasis on technology in the delivery of financial services quickly draw focus to public-interest issues such as access to financial services, privacy and consumer protection. Demographic and economic trends, plus government's response to the pressure placed on Canada's social safety net, increase the importance of a well-functioning financial services sector in Canada. Governments must also react to industry restructuring, which is itself a response to these same forces of change. The increasing complexity and changing nature of financial services raise questions about whether regulators will have the ability to keep up with the changes and, accordingly, what the appropriate supervisory model to ensure safety and soundness of the financial system should be.

Policy Implications

The forces of change will continue to dramatically transform the Canadian financial services sector. Canadians have experienced a substantial evolution in the sector over the last decade, and more change will be required if we are to be well served by our financial institutions as we enter the next century. Regulatory policy aimed at preserving the status quo is not a viable option.

As the financial sector quickly evolves in response to the forces of change, government must act urgently to address the challenge that this transformation poses for setting public policy. Flexible and effective regulatory policies are needed now more than ever in order to offer Canadians greater access to world-class financial services, while providing Canadian institutions with opportunities to compete in both domestic and international markets. Ensuring a flexible, responsive regulatory system, in which change can be managed for the benefit of Canadians, will demand ongoing and focussed attention from policy makers, regulators, industry leaders and customers alike.

[34] Further information on these initiatives is provided in Chapter 5 of Background Paper #5, *Improving the Regulatory Framework.*

Chapter 3

Overview of the Sector

There is a tendency in Canada to focus only on the large Schedule I banks when discussing the financial services sector. This is understandable given the large size and highly visible national presence of the banks. But it is important to remember that the sector includes far more than these banks: it also encompasses foreign-owned and smaller domestic banks, life and general insurance companies, agents and brokers, trust companies, caisses populaires, credit unions, mutual funds, securities dealers, pension managers and investment advisers, as well as specialized finance companies.

It is also common to focus on Canada as a national market. While this approach is important, it can obscure the fact that there are significant regional differences in financial services markets. Further, as noted throughout the work of the Task Force, the position of Canada within North American and world markets cannot be ignored.

This chapter provides an overview of the financial sector in Canada, including a brief discussion of its history, and a focus on the significant regional differences in selected markets. This necessarily has an institutional focus. The Task Force, as noted throughout its work, is very aware of the convergence that has taken place in the financial sector. Where possible, a functional perspective is provided, but much of the data is available only on an institutional basis.

Historical Overview

Canadians today can choose from a wider range of suppliers of financial services than at any other time in our history, although it is easy to lose sight of this fact when considering the recent changes in the industry. The issues and concerns of today are not new, and it is useful to consider their historical context. There have been two previous major examinations of the financial services sector in Canada: the Macmillan Commission in 1933 and the Porter Commission in 1964.

In 1933, despite the impact of the Great Depression, Canada's financial system had not experienced the wave of failures that had plagued the United States. Stability may have had its price, however, as even 65 years ago there were only 10 chartered banks in Canada. By the time of the Porter Commission, consolidation had reduced this number to 8, with the 3 largest holding 70 percent of

banking assets.[35] By contrast, today there are 11 Canadian-controlled chartered banks, and over 40 foreign-owned banks. The three largest have 52 percent of the banking assets in Canada.[36]

In 1933, the life insurance sector accounted for about 33 percent of total financial sector assets, versus about 45 percent for chartered banks. While the amount of total assets held by these traditional intermediaries has increased significantly over time, the share of financial sector assets held by banks and insurance companies has declined to about 37 percent and 9 percent respectively.[37] This decline reflects the continuation of the trend noted in the Porter Commission report of the emergence of new types of institution and new methods of financing. For example, credit unions and caisses populaires were still in their infancy in 1933, but by 1964 had assets of about $1.5 billion, which was equivalent to one third of the size of the largest bank. Today, credit unions and caisses populaires have about 10 percent of the assets of all deposit-taking institutions in Canada and, as noted later in this chapter, have a much stronger presence in some regions of the country than these national numbers suggest. Trust companies enjoyed a boom period from the mid-1960s to the late 1980s, and during the 1980s they collectively held more assets than the credit unions and caisses populaires. Today, trust companies are roughly half as big as the cooperative sector.

Large Canadian businesses have become much less dependent on traditional intermediaries for their financing. Commercial paper and bankers' acceptances, which accounted for an insignificant portion of the debt of Canadian businesses in 1933 and 1964, accounted for about 25 percent of short-term business credit in 1997.[38] The relative importance of bank loans has decreased as non-bank lenders, such as the specialized financing companies, have grown.

One of the reasons for the changing financing sources of Canadian businesses has been the growth of pooled funds. In 1997, pension funds and mutual funds combined held 27 percent of the commercial paper and bankers' acceptances issued by Canadian corporations, up from about 6 percent in 1964. The ever-growing appetite of these pooled funds for marketable securities has also led to a new form of funding for traditional loans. While in 1964 loans to businesses were typically made by banks and funded by deposits, there has been a recent growth in specialized financing companies raising their funds in the capital

[35] *Report of the Royal Commission on Banking and Finance* (Ottawa: Queen's Printer, 1964), p. 2.

[36] Total assets in Canada from Statistics Canada, cat. no. 61-008, *Quarterly financial statistics for enterprises*; assets for individual banks estimated from OSFI data and annual reports (see Exhibit 3.9 later in this chapter).

[37] Statistics Canada National Balance Sheet Accounts.

[38] *Bank of Canada Review,* Table E-2, December 1997.

markets or by securitization. This is reflected in the introduction of a new category, Issuers of Asset-Backed Securities, into the 1997 Statistics Canada National Balance Sheet Accounts. Issuers of asset backed securities had about $40 billion outstanding in 1997, with about $10 billion of this representing loans or leases to business.[39] Many of these asset-backed securities are purchased by Canadian institutional investors.

There is clearly a greater range of options available to large businesses than to small and medium-sized enterprises (SMEs). Only the larger firms can directly access the capital markets and international lenders. However, even for SMEs there are now more options than previously existed. Over the long term, the growth of the cooperative sector and specialized financing companies has increased the options for the small and medium-sized business sector. Consider that in 1933 and 1964 credit unions and caisses populaires had an insignificant share of small business financing, and in 1996 accounted for almost 15 percent of SME business debt financing.[40] Similarly, specialized financing companies have recently experienced rapid growth and now hold about 16 percent of the SME debt financing market, up from just 9 percent in 1994.[41]

The Financial Services Sector Today

Exhibits 3.1 and 3.2 provide an overview of the current institutional structure of the Canadian financial sector.

Exhibit 3.1
Canadian Assets of Financial Institutions, 1997

	$ billions	Percentage of total
Chartered banks (Schedule I and II)	897.5	56.1
Trusts (excl. bank subsidiaries)	53.6	3.4
Credit unions and caisses populaires	107.0	6.7
Life insurers	178.3	11.2
Property and casualty insurers	53.6	3.4
Securities dealers (excl. bank subs.)	28.7	1.8
Mutual funds	280.8	17.5
Total	1,599.5	100.0

Source: Statistics Canada, cat. no. 61-008.

39 Other sources provide differing estimates of securitized assets outstanding, but the story in terms of growth of this financing vehicle is consistent. See Background Paper #4, Chapter 4.

40 Catherine Moser and Pierre Vanasse, *What's New in Debt Financing for Small and Medium-Sized Enterprises* (Ottawa: The Conference Board of Canada, 1997), p. 28.

41 Ibid.

Exhibit 3.2
Financial Services Sector Overview, 1997

	No. of companies	Total assets ($ millions)	Capital ($ millions)	Total revenue ($ millions)	Net Income[1] ($ millions)	Employees
Banks	55	1,321,930	55,667	83,718	7,491	194,800
Canadian	11	1,229,902	50,651	77,976	7,087	N/A
Foreign	44	92,028	5,016	5,742	404	N/A
Trusts (excludes bank subs.)	34	53,538	2,348	5,406	557	22,900
Credit Unions and Caisses Populaires	2,289	106,988	6,825	7,947	488	61,600
Life Insurance Companies[2]	131	233,365	28,002	58,288	2,633	60,770
Canadian	45	208,411	23,629	N/A	2,432	N/A
Foreign	86	24,954	4,373	N/A	201	N/A
Independent Life Agents	N/A	N/A	N/A	N/A	N/A	40,400
P&C Insurance[3]	236	53,310	15,513	21,578	1,839	37,055
Canadian	89	N/A	N/A	6,953	N/A	N/A
Foreign	147	N/A	N/A	14,625	N/A	N/A
Insurance Brokerages	N/A	N/A	N/A	N/A	N/A	56,885
Independent Adjusters and Appraisers	N/A	N/A	N/A	N/A	N/A	3,865
Securities Dealers (includes bank subs.)	187	158,200	3,526	8,478	769	32,900
Mutual Funds	78	280,100	N/A	N/A	N/A	35,000
Asset-Based Financing and Leasing[4]	130	50,000	N/A	N/A	N/A	N/A

Note: Assets, Capital, Total Revenue and Net Income include foreign and domestic operations of Canadian financial institutions and foreign firms operating in Canada.

1 Net Income is after tax and excludes preferred share dividends of $481 million for domestic banks, and an estimate of $16 million preferred share dividends for trusts and $52 million for life insurance companies. Net Income for life insurance companies is after policy-holder dividends of $2,387 million.

2 All life insurance data are for 1996.

3 Number of companies and employment data for property and casualty insurance are for 1996.

4 Estimated by the Canadian Finance and Leasing Association based on its 1996 member survey.

N/A = Not available.

Sources: Revised and updated by the Task Force from *The Canadian Financial Services Industry: The Year in Review* (Ottawa: The Conference Board of Canada, 1997). Banks: Number of banks, total assets and capital are from OSFI as at December 31, 1997, presented on a consolidated basis. Total revenue is total interest income plus non-interest income. Total revenue and net income are from OSFI for the banks' fiscal years ended October 31, 1997, with Net Income reduced by $481 preferred share dividends paid by the 7 largest Canadian banks. Number of employees at December 31, 1997 from Statistics Canada 72-002-XPB. This total excludes employees in non-banking subsidiaries such as investment dealers. The CBA estimates total bank employment including subsidiaries as 221,400. Trusts:

Exhibit 3.2 (continued)

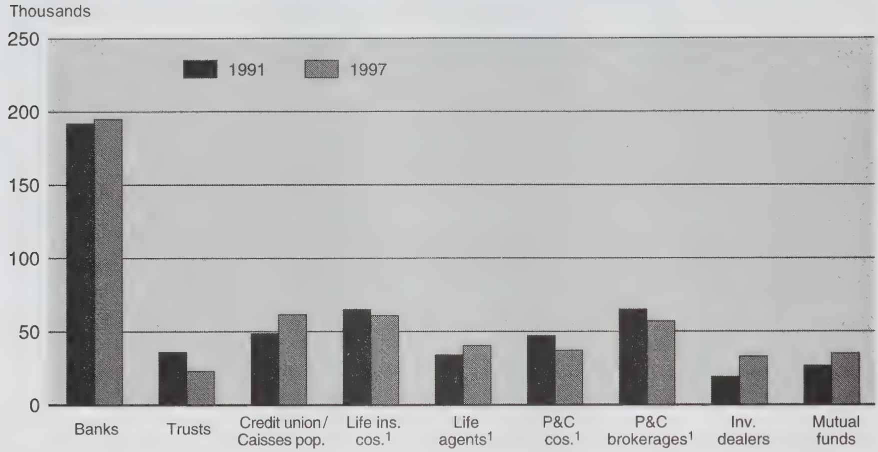
Number of trust companies estimated by deducting bank-owned trust companies from Canada Deposit Insurance Corporation member trust companies as at March 31, 1997. Groups were counted as a single institution. Assets, capital, total revenue (interest income and other income) and net income from Statistics Canada 61-008 for the year ended December 31, 1997. Net income adjusted to deduct $16 million preferred share dividends paid by Canada Trust. Number of employees at December 31, 1997 from Statistics Canada 72-002-XPB. Credit Unions and caisses populaires: Local credit unions and caisses only; centrals and affiliates are excluded. Number of institutions includes 1,275 caisses populaires in Quebec, 141 caisses populaires outside Quebec (New Brunswick, Ontario and Manitoba), and 873 credit unions. All data are from Credit Union Central of Canada and The Mouvement Desjardins for year ended December 31, 1997. Life insurance companies: Data are from the Canadian Life and Health Insurance Association for the year ended December 31, 1996. Assets include segregated funds and foreign branches but not foreign subsidiaries. Net income has been adjusted to deduct $52 million in preferred share dividends paid by Great-West Lifeco, London Life and Crown Life. The division of companies is based on nationality (not registration). Property and casualty insurance: There are 231 federally registered companies and an estimated 200 provincially registered companies. Many of these companies are not writing new business, and there is some double counting as companies may have multiple provincial registrations. The Insurance Bureau of Canada estimates that there are 230 active P&C insurers in Canada. Assets, capital and net income for the year ended December 31, 1997 from Statistics Canada 61-008. Total revenue excludes government-owned insurers. Total revenue data for 1997 are from *Canadian Insurance,* Annual Statistical Issue, June 1988, and includes net premiums earned plus operating investment income. Employment data are for 1996 from the Insurance Bureau of Canada. Securities dealers: Investment Dealers Association of Canada. Mutual Funds: Total companies equals Investment Funds Institute of Canada members (funds managers) as at December 1997. Total assets from Statistics Canada 61-008. Employment estimated by the Investment Funds Institute of Canada. Asset-based financing and leasing: The number of companies and total assets are estimated by the Canadian Finance and Leasing Association based on its 1996 survey of member companies. Total assets of survey respondents were $30.7 billion.

Within Canada, the sector accounts for direct employment of more than half a million Canadians and provides a weekly payroll of over $425 million.[42] Employment in the regulated financial sectors remained relatively constant from 1991 to 1997 (see Exhibit 3.3). Decreases in all types of insurance and the trust sector were offset by growth in the banking and credit union and caisse populaire sectors, and most dramatically in the securities and mutual funds sectors. The decreases in employment in the property and casualty sector reflect consolidation in the industry and the efforts of companies and brokerages to improve their efficiency. The decline of 13,100 employed in the trust sector was partially offset by an increase of 2,600 in the banking sector. (This increase excludes employees in the banks' securities and insurance subsidiaries, which are included by Statistics Canada in the employment totals for the securities and insurance sectors.)

Given the consolidation trends in the industry and the ongoing search for operating efficiencies, there is unlikely to be any significant overall increase in employment in the sector in the foreseeable future. Increasing business volumes are likely to be accommodated through efficiency increases, and employment

42 Statistics Canada, *Earnings, Employment and Hours*, cat. no.72-0002-XPB. Total employment in the financial, insurance and real estate sector was 712,500 as at December 31, 1997. Estimated employment for the financial sector alone was approximately 550,000 (712,500 less 97,600 real estate operators and an estimated 65,000 employees of real estate agencies). Weekly payroll for the sector at December 1997 was $541 million. Deducting real estate operators and real estate agencies leaves a financial sector payroll of over $425 million.

Exhibit 3.3
Employment in the Financial Sector



[1]1996 data

Sources: See notes to Exhibit 3.2.

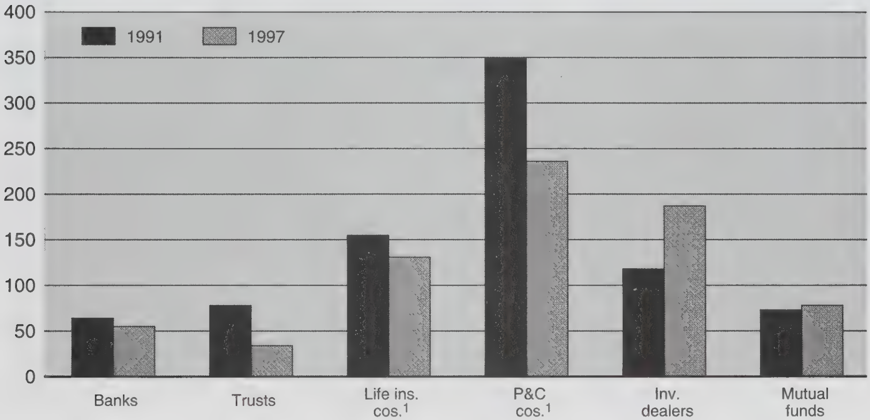
growth in sectors such as the mutual fund industry will be offset by contraction in other sectors.

The consolidation trends in the industry and increasing concentration in virtually all sectors and markets are reflected in the change in the number of financial services firms in Canada since 1991 (see Exhibit 3.4). As with employment, the reasons for the changes vary by sector.

After lagging behind the return on equity (ROE) of the non-financial sector throughout the 1980s, the financial sector as a whole has outperformed the rest of the Canadian economy since 1990 (see Exhibit 3.5). Securities dealers have been the most profitable, averaging an ROE of about 25 percent since 1991. The large domestic banks have also been highly profitable, with much of their increase in profitability in the 1990s attributable to earnings in their securities subsidiaries and other fee-for-service businesses, and a sharp decline in provisions for loan losses.

The financial services sector contributes significant tax revenues to all levels of government in Canada. Various industry groups have highlighted for the Task Force how they are particularly targeted by, for example, premium taxes on insurance polices and capital tax surcharges for large deposit-taking institutions. Without attempting to resolve whether each part of the financial services industry is taxed "fairly" relative to other financial services firms and other taxpayers, it is clear that the taxes paid by the financial sector have increased substantially through the 1990s (see Exhibit 3.6).

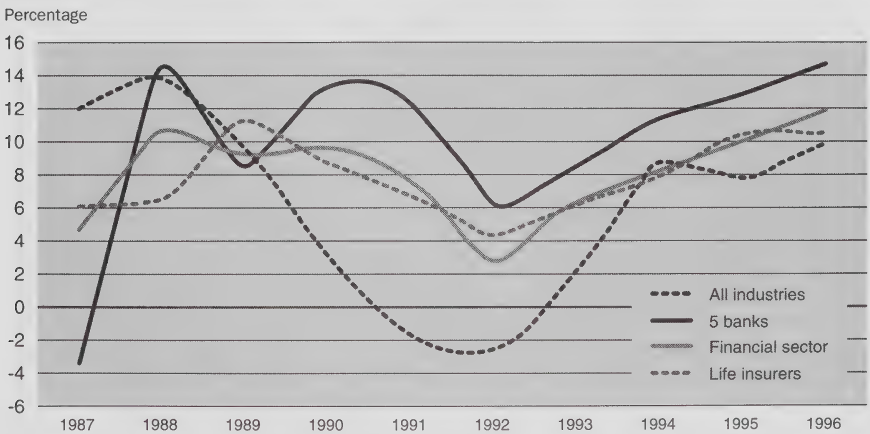
Exhibit 3.4
Number of Financial Services Firms in Canada



[1] 1996 data

Sources: See notes to Exhibit 3.2.

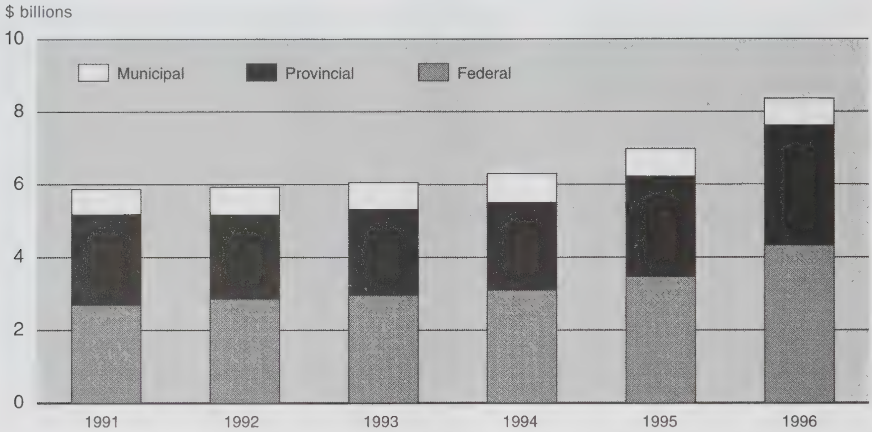
Exhibit 3.5
Return on Equity



Sources: All industries, Statistics Canada, cat. no. 61-008, Life Insurance, Financial Sector; The Conference Board of Canada; 5 largest banks, annual reports.

Exhibit 3.6

Total Taxes Paid by the Financial Sector



Source: *Supporting Governments 1997 Edition,* The Conference Board of Canada.

A brief discussion on how the forces of change have affected each sector follows.

The Deposit-Taking Sector

The deposit-taking sector has changed significantly since 1991. The 1992 federal legislation recognized what had long been evident in the market: the traditional trust and bank pillars had merged into a single deposit-taking sector. More important, the business of the deposit-taking institutions has changed, with the traditional spread-earning intermediation business becoming less important.

As detailed in Chapter 2, Canadians are increasingly placing their savings in instruments other than conventional deposits (see Exhibit 3.7) and, for the largest companies, direct access to the capital markets has supplanted the role of large corporate bank loans. While the intermediation business is still important, it has become increasingly difficult to earn wide margins given intense competition, and the growth in profitability for deposit-taking institutions is coming from fee-based businesses such as mutual funds and wealth management. This trend toward narrowing interest rate margins and increasing fee-based revenue is illustrated in Exhibit 3.8.

Exhibit 3.7

Personal Savings by Type of Institution ($ billion)

	Bank personal deposits	Trust personal deposits	CU & CP deposits	Mutual funds
1991	216.5	114.7	68.4	49.9
1992	228.7	113.3	73.7	67.3
1993	263.8	79.5	78.0	114.6
1994	280.3	68.7	81.9	127.3
1995	297.5	64.4	87.2	146.2
1996	292.4	62.9	90.8	211.8
1997	290.3	48.2	90.6	283.2

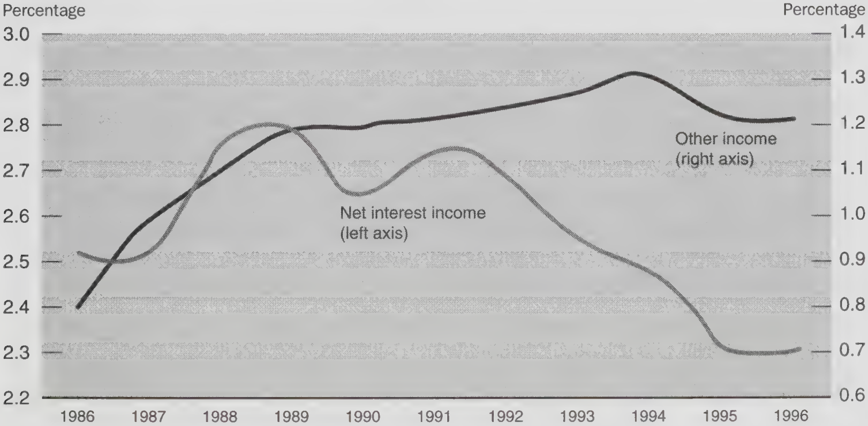
CU & CP = credit union and caisses populaires.

Sources: Bank of Canada, Investment Funds Institute of Canada.

Exhibit 3.8

Bank Net Interest Income and Other Income

Percentage of Total Assets



Sources: Bank of Canada, Canadian Bankers Association, The Conference Board of Canada.

There are currently 11 Canadian-controlled banks, and they have about 90 percent of banking assets in Canada, with the 6 largest accounting for virtually all of the market (see Exhibit 3.9). This number has increased by 2 since 1996 with the incorporation of First Nations Bank and Citizens Bank, a subsidiary of Vancouver City Savings Credit Union (Van City), the largest credit union in Canada. Using the broader measure of deposit-taking institution (DTI) assets, the domestic bank share is about 76 percent (see Exhibit 3.10), which reflects the important role played by trust companies, credit unions and the caisses populaires in Quebec.[43]

Exhibit 3.9
Assets of Domestic Banks

Bank	Total assets ($ millions 1997)	Assets in Canada ($ millions 1997)
Royal Bank of Canada	262,865	188,737
Canadian Imperial Bank of Commerce	277,677	156,610
Bank of Montreal	227,752	126,630
Bank of Nova Scotia	206,016	123,813
Toronto-Dominion Bank	172,974	117,968
National Bank	66,981	56,872
Laurentian Bank of Canada	12,467	12,464
Canadian Western Bank	2,007	2,022
Citizens Bank	805	805
Manulife Bank of Canada	346	346
First Nations Bank	11	11

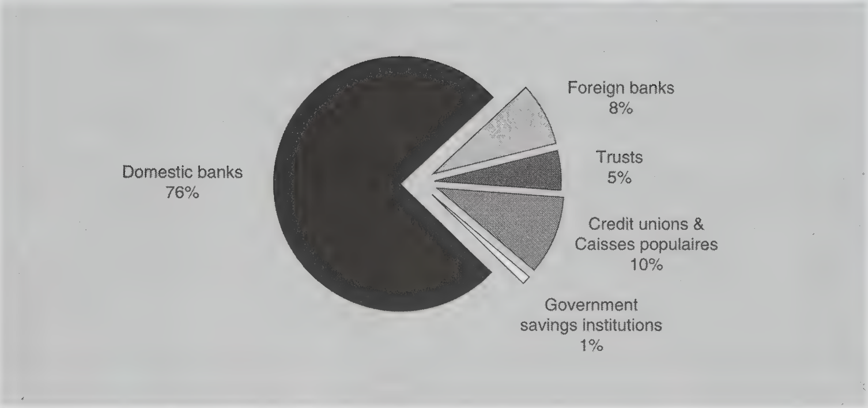
Sources: Total assets from Office of the Superintendent of Financial Institutions Web site for December 31, 1997. Assets in Canada for some banks from OSFI individual bank data, used with permission of the institutions. Assets in Canada for others provided by the institution or estimated from October 1997 annual report data.

There was a net exit from the Canadian market of 12 foreign banks from 1991 to 1997. In some cases this consolidation was the result of a merger between two banks that both previously had a presence in Canada. In other cases, it reflected a decision to withdraw because of poor profitability in Canada or a decision to refocus for other reasons.

At their peak between 1988 and 1991, trust companies accounted for about 22 percent of deposits in Canada. With the failure of a number of large and

43 Market share data presented throughout this chapter should be interpreted as indicative of general levels of concentration. Precise market share calculations are difficult. Data on total size of markets as published by the Office of the Superintendent of Financial Institutions, the Bank of Canada and Statistics Canada vary somewhat because of differences in definitions and differences in collection methodologies. Data reported by companies in annual reports also contain differences in definitions. As a result, market shares can differ by several percentage points depending on the data sources used.

Exhibit 3.10
DTI Assets in Canada, 1997
$1,038 billion



Sources: OSFI, Statistics Canada, Bank of Canada, Credit Union Central of Canada.

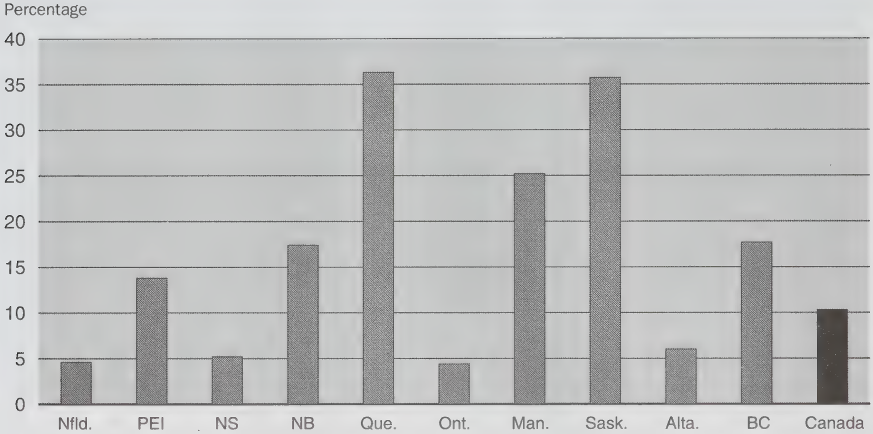
smaller trust companies in the 1980s and early 1990s, and several acquisitions by banks, there is now only one large independent trust company, Canada Trust, and about 30 much smaller institutions. Collectively trust companies now have about 9 percent of deposits.

However, the overall reduction in the number of banks and trusts obscures the fact that several vigorous new competitors have recently entered Canada. A Canadian subsidiary of the International Nederlanden Groupe (ING), the large Netherlands insurance and banking conglomerate, is now competing using electronic delivery across the country, as is Citizens Bank. Specialized monoline banks, MBNA and Capital One Financial, have recently targeted the Canadian credit card market. It is too soon to determine how successful these new entrants will be, but they are tangible evidence of the potential for a greater number of competitors in the banking sector.

The cooperative banking sector is the strongest illustration of the regional differences in the financial services sector. As shown in Exhibit 3.10, the assets of credit unions and caisses populaires (excluding assets of Centrals and affiliates) amount to approximately 10 percent of deposit-taking institution assets in Canada. However, the cooperative sector is far more important in Quebec and Saskatchewan, with assets equal to 36 and 35 percent respecetively of DTI assets in those provinces (see Exhibit 3.11). Manitoba, British Columbia, New Brunswick and Prince Edward Island also have cooperative sectors that are much better developed than the national numbers would suggest.

Exhibit 3.11

Credit Union and Caisse Populaire Share of Deposit-Taking Institution Assets, 1997



Note: Provincial bank and trust company assets exclude head office and unallocated assets in Canada; credit union and caisse populaire data exclude centrals and affiliates.

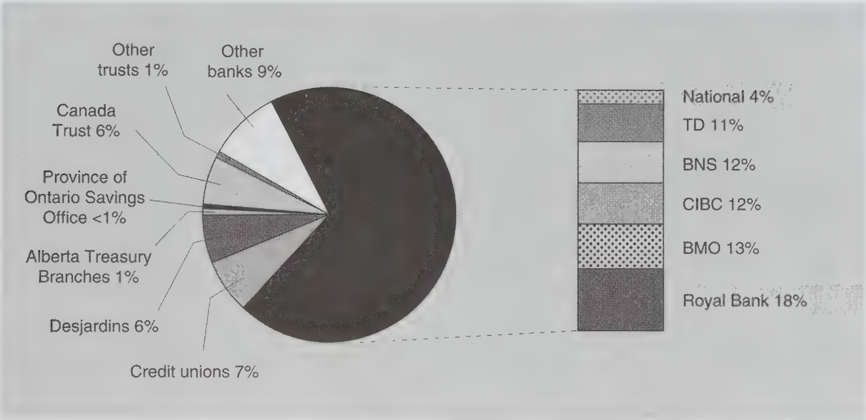
Sources: Bank of Canada, Statistics Canada, Credit Union Central of Canada, Alberta Treasury Branches.

Banks collectively have about 79 percent of all deposits in Canada, with the six largest having 70 percent (see Exhibit 3.12). However, these national numbers obscure strong regional variations. For example, in Quebec, Le Mouvement des Caisses Desjardins (Desjardins) and the National Bank of Canada are the leading players.[44] In Saskatchewan, credit unions collectively have a larger share of the deposit-taking market than any of the banks, while the Alberta Treasury Branches rank third in that province behind the Royal Bank and CIBC. In British Columbia, credit unions collectively are a close second to the Royal Bank in their share of the deposit market, and the Hongkong Bank of Canada probably ranks among the five largest players in the province.[45]

[44] Desjardins estimates that its share of traditional deposits in Quebec is 44 percent, with the National Bank holding about 16 percent. See *En perspective*, Desjardins études économiques, March 1998. The individual banks do not generally make data on regional distribution of deposits available. In response to requests by the Task Force, some deposit-taking institutions provided permission to use detailed OSFI filings which contain this data and others provided data directly to the Task Force. As some institutions declined to make the data publicly available, the Task Force was unable to develop definitive market shares by province. However, based on estimates from the incomplete data available to the Task Force and publicly available sources, Desjardins is clearly the market leader in Quebec.

[45] There may be some variation in these market share estimates given the data estimation noted in the previous footnote. However, even incomplete data make it clear that the institutions noted have very significant shares in the individual provincial markets.

Exhibit 3.12
Deposits in Canada, 1997
$714 billion



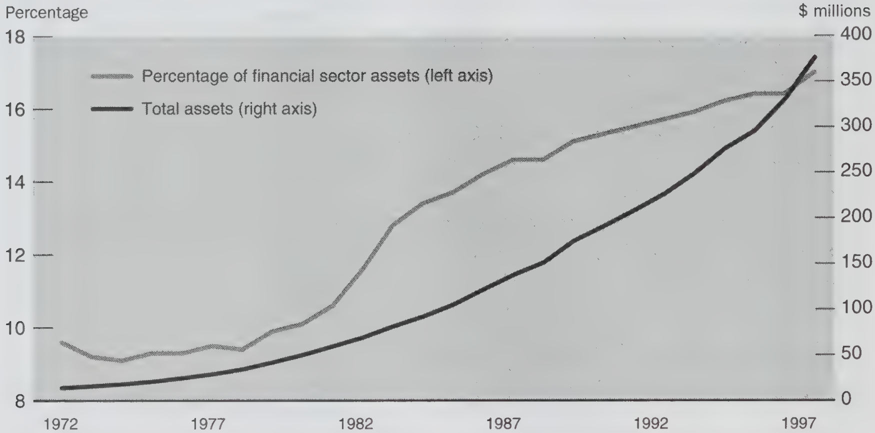
Sources: Bank of Canada, OSFI, Annual Reports, Credit Union Central of Canada.

Pooled Funds

Deposits are becoming less significant to Canadians as repositories of savings. Mutual fund holdings have surpassed total personal bank deposits in 1998, and if current growth rates continue, they will soon surpass the total of all personal deposits held in Canada (see Exhibit 3.7 earlier in this chapter). The mutual fund industry has grown dramatically in Canada, increasing its assets almost sixfold between 1991 and 1997. The traditional deposit-taking institutions have responded to this shift in consumer preference by competing strongly in the mutual fund sector. However, the market share of the DTI-run mutual funds declined from 37.5 percent in 1991 to 30.2 percent in May 1998, a fall indicative of the intense competition in this market. While the number of mutual fund companies only increased by 5 from 1991 to 1997, with new entries balancing acquisitions, mergers and exits, the number of individual funds has mushroomed from 294 to 1,023.

Trusteed pension plans have increased their share of financial sector assets from just under 10 percent in 1972 to 17 percent at the end of 1997 (see Exhibit 3.13). The largest pension funds are all defined-benefit plans (see Exhibit 3.14), and have grown substantially as a result of the buoyant stock markets of the last few years.

Exhibit 3.13
Trusted Pension Plans



Source: Statistics Canada National Balance Sheet Accounts.

Exhibit 3.14
Largest Trusteed Pension Funds, 1997

Fund	Assets ($ millions)	Percent of Total Trusteed Pension Assets
Ontario Teachers	52,948	14.0
Quebec Public Employees	49,000	13.0
OMERS	29,520	7.8
Hospitals of Ontario	13,093	3.5
B.C. Municipal	10,985	2.9
BCE Inc.	10,462	2.7
Ontario Hydro	10,097	2.6
Ontario Pension Board	10,029	2.6
CN Railways	9,874	2.6
B.C. Public Service	9,226	2.4

Sources: Individual Funds, Benefits Canada; Total Trusteed Pension Assets, Statistics Canada National Balance Sheet Accounts.

Since the bulk of pension fund assets is invested in liquid securities, the increasing portion of household savings held in pooled funds such as pension funds and mutual funds is changing the nature of savings intermediation. With the ever-increasing appetite of fund managers for eligible investments and the

Exhibit 3.15
Largest Money Managers, June 1997

Company	Assets under management ($ millions)
Caisse de Dépôt et Placement du Québec	64,000
TD Asset Management	36,531
T.A.L. Investment Counsel	35,885
Phillips, Hager & North	26,583
RT Capital Management	25,990
Top 40 Total	470,000

Source: Benefits Canada.

shrinking portion of savings flowing into deposits, funding requirements for mortgages, consumer loans and business credit will increasingly be met through securitized assets. The process of securitization transforms relatively illiquid investments such as mortgages into liquid securities suitable for purchase by pension funds and mutual funds.

The growth in pooled funds has also led to a sharp increase in the money management business. Many pension funds contract asset management to specialized firms. Further, the terms of a trusteed pension plan require that the assets actually be held by a trustee, and securities are held (frequently in an electronic format) by a custodian. This multiplicity of players can lead to double counting, as the assets managed by specialized firms are generally "owned" by a trusteed pension fund, held in trust by a trust company and administered by a custodian.[46]

Property and Casualty Insurance

The property and casualty (P&C) insurance sector differs from the rest of the regulated financial sector in two ways.[47] First, unlike the other sectors, whose core business is dealing with Canadians' savings, the P&C business is strictly transactional. A fee is paid for risk protection for a specified period. The second way in which the P&C sector differs is that it is dominated by foreign-owned

[46] It has been suggested that every dollar touched in any one of these functions should be included in determining the share of assets held by, for example, the banks. See Power Financial Corporation, *Submission to Task Force on the Future of the Canadian Financial Services Sector,* (November 1997). However, this results in double and triple counting of assets, and there is a distinction between assets held as a custodian, where the custodian holds and delivers securities and settlements on the basis of instructions received, and assets where the institution actually has control over the investment decisions.

[47] For more detail, see Coopers & Lybrand, *The Property/Casualty Insurance Industry,* Research Paper Prepared for the Task Force on the Future of the Canadian Financial Services Sector (Ottawa, September 1998).

institutions. While there are many vigorous Canadian competitors, foreign-owned companies accounted for about 68 percent of net premiums earned in Canada in 1997, up from about 63 percent in 1991.[48]

The sector is undergoing significant consolidation, as illustrated by the declines in both the number of firms and employment since 1991 (see Exhibits 3.3 and 3.4). This is reflected in a substantial increase in concentration, although the P&C sector is still the least-concentrated part of the financial services sector. The brokerage portion of the business is also undergoing consolidation, driven by both the existing players' attempts to become more efficient through investment in technology and the growth in alternative distribution channels such as call centres. Employment in insurance brokerages has declined by 13 percent since 1991.

There are significant regional variations in the property and casualty insurance market in Canada, largely because of the presence of government-owned auto insurers in four provinces. It is customary in the industry to exclude government-owned insurers in determining market share (as was done in Exhibit 3.16). However, auto insurance is the single-largest part of the general insurance business, so consideration of the role of the Insurance Corporation of

Exhibit 3.16
Property and Casualty Insurance
Direct Premiums Written in Canada

1997	**($ millions)**	**Share**
General Accident Group	1,498	7.7%
Royal and Sun Alliance	1,247	6.4%
ING Canada	1,144	5.8%
Co-operators	986	5.0%
AXA Canada	902	4.6%
State Farm	817	4.2%
Zurich Canada	745	3.8%
Economical Insurance	721	3.7%
Wawanesa Mutual	657	3.4%
Guardian Group	632	3.2%
Industry Total[1]	19,559	100.0%

[1] Excludes government-owned insurers.

Source: *Canadian Insurance*, Annual statistical issue, June 1998.

[48] Excludes premiums written by government-owned insurers. *Canadian Insurance*, Annual Statistical Editions, 1992 and 1998.

British Columbia, SGI,[49] Manitoba Public Insurance Corporation and the Société d'assurance automobile du Québec is especially appropriate when considering regional markets (see Exhibit 3.17). The government-owned insurers dominate their regions when the market is defined to include them.

Exhibit 3.17
Leading General Insurers – Percentage of Net Premiums Written in Canada, 1997

Atlantic		**Quebec[1]**		**Ontario**	
Co-operators	11.2%	Société de l'assurance automobile du Québec	12.7%	State Farm	7.7%
General Accident Group	10.9%	AXA Canada	11.5%	General Accident Group	7.3%
Royal and Sun Alliance	10.7%	Desjardins Groupe	10.0%	Royal and Sun Alliance	7.1%
ING Canada	6.3%	ING Canada	9.6%	Co-operators	5.8%
Economical Insurance	5.5%	General Accident Group	6.7%	Liberty Mutual Group	5.4%
Lloyd's of London	4.8%	Guardian Group	4.2%	Economical Insurance	4.8%
Guardian Group	4.5%	Royal and Sun Alliance	3.6%	Zurich Canada	4.8%
AXA Canada	3.9%	Lloyd's of London	2.7%	Dominion of Canada General	4.2%
Lombard Canada Group	3.4%	Lombard Canada Group	2.3%	ING Canada	4.0%
Wawenesa Mutual	3.3%	Economical Insurance	2.2%	Lombard Canada Group	2.4%
Man. & Sask.[1]		**Alberta**		**B.C.[1] + Terr.**	
Man. Public Ins. Corp	32.5%	Co-operators	8.5%	Ins. Corp. of B.C.	60.5%
SGI-Auto Fund	21.7%	Wawenesa Mutual	8.3%	General Accident Group	2.9%
SGI Canada	9.8%	General Accident Group	7.8%	Lloyd's of London	2.2%
Wawenesa Mutual	4.4%	ING Canada	6.3%	AXA Canada	2.2%
General Accident Group	2.9%	Royal and Sun Alliance	5.0%	Royal and Sun Alliance	2.1%
Royal and Sun Alliance	2.5%	Zurich Canada	3.9%	Guardian Group	2.0%
Co-operators	2.5%	Economical Insurance	3.3%	ING Canada	2.0%
ING Canada	1.3%	Guardian Group	3.0%	Zurich Canada	1.7%
Lombard Canada Group	0.8%	Dominion of Canada General	2.8%	Dominion of Canada General	1.4%
Zurich Canada	0.7%	State Farm	2.7%	Wawenesa Mutual	1.4%

1 The Société de l'assurance automobile du Québec does not report on a direct premium written basis. The market share of this Quebec government insurer is estimated based on 1997 fees charged for vehicle registration and drivers' licences. The estimated total Quebec market consists of $566 million collected by the Société de l'assurance automobile du Québec, plus $3.8 billion in direct premiums written in all lines of insurance by private-sector companies in Quebec. Markets in Manitoba, Saskatchewan and British Columbia include provincial total direct premiums written for all lines of insurance by private-sector companies, plus direct premiums written by the government-owned insurers in each province as reported in *Canadian Insurance*, Annual Statistical Issue, June 1998.

Sources: *Canadian Insurance*, Annual Statistical Issue, June 1998, and the Société de l'assurance automobile du Québec.

49 SGI operates as two entities: SGI-Auto Fund, which provides the compulsory auto insurance in Saskatchewan, and SGI Canada, which competes in other lines of insurance.

Life Insurance

Life insurance, like the rest of the financial services sector, has been characterized by consolidation in the 1990s. This is reflected in the decrease in the number of firms and employment since 1991 (see Exhibits 3.3 and 3.4). The increase in the number of licensed life insurance agents of 6,000 since 1991 is deceptive.[50] A major factor driving this increase is the number of licensed securities salespeople who are obtaining life insurance licences to enable them to provide insurance advice as part of a broader financial planning business. The number of full-time licensed agents declined by 4.5 percent between 1986 and 1996, and the average Life Underwriters Association of Canada (now Canadian Association of Insurance and Financial Advisors) member sold 27 percent fewer policies in 1996 than in 1987.[51]

As with the deposit-taking sector, the life insurance sector has changed to meet new demands in the marketplace. Traditional life insurance products declined as a percentage of household financial assets through the 1970s and 1980s. The industry responded by developing new products such as universal life insurance, which features a market-linked rate of return. Over the last few years, most of the growth in the life insurance business has come from new kinds of investment products, and the importance of traditional life insurance has declined. Segregated funds, which are similar to mutual funds but have a life insurance component, have grown much faster than the traditional life insurance business since 1992 (see Exhibit 3.18). Life insurance companies have also moved to capture more individual savings by offering mutual funds. Since 1992, the growth of mutual funds owned by life insurance companies has far exceeded the nominal growth in the traditional life insurance business.

Even before the recent acquisition of London Insurance Group by Great-West Life and Metropolitan Life by Mutual Life, plus the proposed Canada Life acquisition of most of the assets of Crown Life, there had been significant consolidation in the sector.

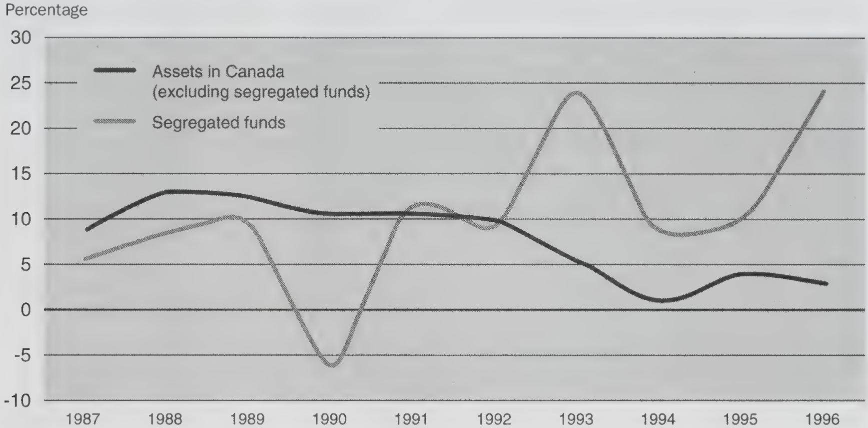
Pro forma estimates accounting for the recent mergers indicate that the five largest life insurance companies will now have approximately 59 percent of the individual market and 62 percent of the group market, up from 42 and 43 percent respectively in 1991 (see Exhibits 3.19 and 3.20).

[50] CLHIA data for 1996 in Exhibit 3.2. 1991 estimated from data provided by the CLHIA.

[51] LIMRA, *Trends in Canadian Insurance*, 1997.

Exhibit 3.18

Life Insurance Company Annual Growth Rates



Source: Canadian Life and Health Insurance Association.

Exhibit 3.19

Individual Life Insurance Premiums[1]

1997	($ millions)	Share
Great-West and London Life	1,450	21.0%
Mutual and Metropolitan Life	1,105	16.0%
Manulife	605	8.8%
Sun Life	465	6.7%
Canada Life and Crown Life	447	6.5%
Industrial-Alliance	246	3.6%
Transamerica Life	182	2.6%
Desjardins-Laurentian	172	2.5%
Maritime Life	170	2.5%
Aetna Life	123	1.8%
Industry Total	6,909	100%

Note: Industry total was adjusted to reflect additional company data received by *Canadian Insurance* that was already reflected in its calculation of market share, but was not included its published industry totals.

1 1997 data excludes Standard Life, which does not make data available on its Canadian branch separate from its parent's operations. Standard Life's Canadian branch would rank within the top ten life insurers in Canada.

Source: *Canadian Insurance*, Annual Statistical Issue, June 1998.

Exhibit 3.20

Group Life Insurance Premiums[1]

1997	($ millions)	Share
Great-West and London Life	383	18.4%
Sun Life	250	12.0%
Manulife	227	10.9%
Desjardins-Laurentian	223	10.7%
Mutual and Metropolitan Life	209	10.0%
Canada Life and Crown Life	198	9.5%
Aetna Life	72	3.5%
Maritime Life	65	3.1%
Co-operators Life	63	3.0%
SSQ-Vie	41	2.0%
Industry Total	2,086	100.0%

See note in Exhibit 3.19.

1 1997 data excludes Standard Life, which does not make data available on its Canadian branch separate from its parent's operations. Standard Life's Canadian branch would rank within the top ten life insurers in Canada.

Source: *Canadian Insurance.*

Exhibit 3.21

Life Insurance Market Share Leaders by Region
Percent of 1997 Total Life and Annuity Premiums[1]

Atlantic		Quebec[2]		Ontario		Prairies		B.C. + Territories	
Mutual and Metropolitan	16.9	Desjardins-Laurentian	18.7	Great-West and London Life	18.8	Great-West and London Life	20.4	Mutual and Metropolitan	14.7
Great-West and London Life	15.6	Great-West and London Life	10.6	Mutual and Metropolitan	14.7	Manulife	14.3	Great-West and London Life	14.1
Sun Life	10.4	Mutual and Metropolitan	9.5	Manulife	12.7	Mutual and Metropolitan	12.7	Manulife	14.1
Canada Life and Crown	9.2	Industrielle-Alliance	7.2	Canada Life and Crown	8.2	Canada Life and Crown	10.3	Canada Life and Crown	11.7
Manulife	8.2	SSQ-Vie	6.3	Sun Life	7.3	Sun Life	9.2	Sun Life	9.8

1 Excludes Standard Life, which does not disclose data on its Canadian branch separately from its parent. Standard Life's Canadian branch would rank among the largest 10 life insurers in Canada.

2 1996 Life Premium data.

Sources: OSFI, *Canadian Insurance*, CLHIA, Desjardins.

Each regional market in Canada has a wide choice of life insurance competitors. More than 85 of the 131 companies in Canada are licensed to do business in every province, with Ontario and Quebec residents able to chose from 117 and 120 companies respectively. There is some regional variation in market share but, as with deposit-taking, the largest life insurance companies have a significant presence in all regions. Also, while the share of Quebec-focussed life insurance companies does not match that of Desjardins in deposit-taking, Desjardins-Laurentian Life, Industrielle-Alliance and SSQ-Vie collectively wrote about 32 percent of all life insurance premiums in the province in 1997 (see Exhibit 3.21).

Securities Dealers

The securities market has evolved significantly since 1987, when the banks were permitted to enter the business. The market is now a distinct barbell: almost all the mid-sized players have disappeared. There has been a growth in the number of niche players, as evidenced by the net increase of more than 90 Investment Dealers Association of Canada (IDA) members since 1986. The bank-owned firms currently have about a 60 percent share of underwriting, about 55 percent of commission revenue and about 65 percent of fixed-income trading.[52]

It is too soon to tell what will be the impact of the acquisition announced in June 1998 of Midland Walwyn, one of the few remaining independent full-service brokerages, by Merrill Lynch. Merrill Lynch, the largest securities firm in the United States, has long been a significant player in the corporate finance market in Canada, and its position is likely to be enhanced through the Midland Walwyn acquisition. Also, because Midland Walwyn had a network of retail brokers, there will now be a much greater element of international competition in a retail market which has been dominated by the domestic bank-owned firms.

Specialized Financing Companies

There are a large number of specialized financing companies, which provide a range of services, primarily to business customers. The largest of this type of company in Canada is Newcourt Credit, which through internal growth and a series of acquisitions has become the second largest finance and leasing company in North America. G.E. Capital, a subsidiary of General Electric, is the largest competitor, with over $57 billion in net financing assets. The importance of these specialized companies is understated because the measurement of assets does not capture those that have been securitized. Some specialized financing

[52] Investment Dealers Association of Canada, *Competing to Serve Canadians – A Securities Industry Perspective*, submission to the Task Force (November 1997).

companies securitize far more loans and leases than they keep on their own balance sheets. Exhibit 3.22 lists the five largest independent finance and leasing companies in North America, ranked by net investment in equipment related loans and leases as reported on company balance sheets at year end 1997.

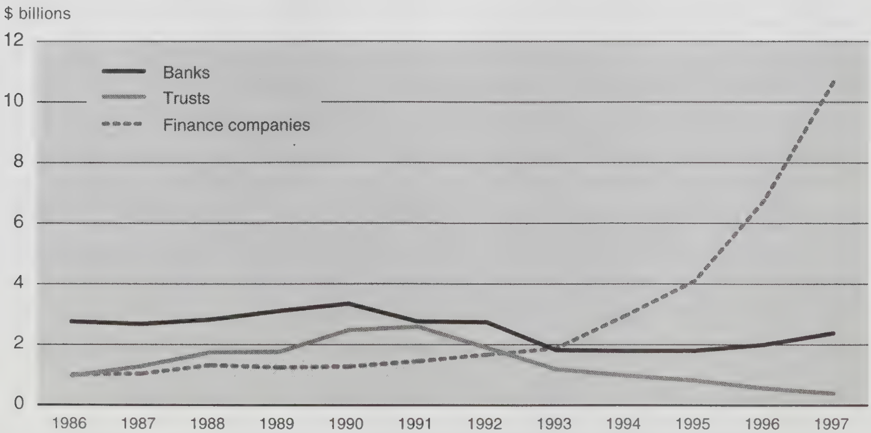
This sector of the industry is populated by two principal types of company: "independents," which finance a range of assets, and "captives," which are controlled by a manufacturer and focus on financing the products of the parent company. There are over 100 of these companies in Canada. Concentration in this sector increased significantly in 1997 with the acquisition by Newcourt of the third- and fourth-largest Canadian competitors, AT&T Capital and Commcorp Financial Services, although there has also been a number of new entrants.

Exhibit 3.22
Largest Independent Finance and Leasing Companies in North America

Company	1997 net assets (US$ billions)
Newcourt Credit Group	20.2
Associates Commercial Corp.	14.8
Comdisco Inc.	5.0
GATX Capital Corporation	4.5
The Finova Group Inc.	4.0

Source: Monitor Leasing and Financial Services, May/June 1998.

Exhibit 3.23
Business Leasing Receivables



Source: Bank of Canada.

Over one third of asset-based financing is done through leasing. While the banks are active in both asset-based lending and lease financing, the companies that specialize in this area generally have a significant advantage in terms of relationships with vendors and in the ability to deal with residual risk and asset disposal. The result is that the bank share of this sector is small and declining (see Exhibit 3.23).

Crown Financial Corporations

There are four federal Crown corporations, as well as a number of provincial government financial enterprises that play an important role in meeting the needs of small and medium-sized enterprises.

The Business Development Bank of Canada (BDC) is a financial institution wholly owned by the Government of Canada, with a mandate to support Canadian entrepreneurship through the provision of financial and management services to small business. The BDC's services are available across Canada through a network of more than 80 branches. As of March 31, 1997, the BDC had just under $4 billion in outstanding loans and guarantees. Of the total value of BDC's outstanding loans and guarantees, 36 percent are made to knowledge-based industries and exporters, with the rest going to traditional industries.

Canadian Commercial Corporation (CCC) was established in 1946. It provides Canadian exporters with a wide range of contracting services which enhance access to market opportunities with foreign governments, international organizations and some private-sector buyers. In 1997-98, CCC concluded contracts worth over $850 million on behalf of 1,310 suppliers. Over 60 percent of CCC's suppliers are SMEs.

Export Development Corporation (EDC) is a Crown corporation that provides export financing and credit insurance on domestic accounts receivable. EDC manages two types of export insurance accounts: the Corporate Account and the Canada Account. With the approval of the Minister for International Trade and the concurrence of the Minister of Finance, EDC will use the Canada Account to provide financial support that would not otherwise be undertaken on a commercial basis. In 1997, the Canada Account facilitated financial arrangements for exporters that totalled $1.9 billion, versus $23.6 billion for the Corporate Account.

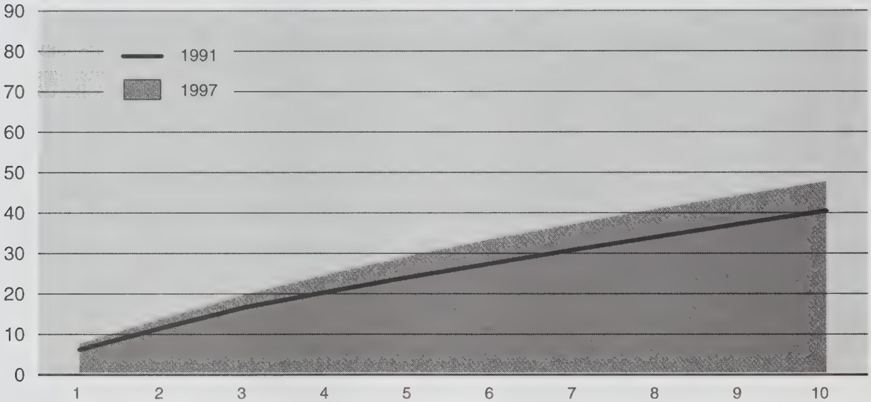
Farm Credit Corporation (FCC), a federal Crown corporation, has a mandate to foster growth in agriculture by providing financial services and federal programs to primary producers, agri-businesses and farming communities. The FCC also delivers joint programs and services with government agencies and other lenders. As Canada's largest agricultural long-term lender, it has a loan portfolio of some 65,000 accounts, valued at over $5 billion.

Market Structure

Consolidation in the financial sector has led to increases in the market shares of the largest financial institutions (see Exhibits 3.24, 3.25 and 3.26).

Exhibit 3.24
Cumulative Market Share
10 Largest General Insurance Companies

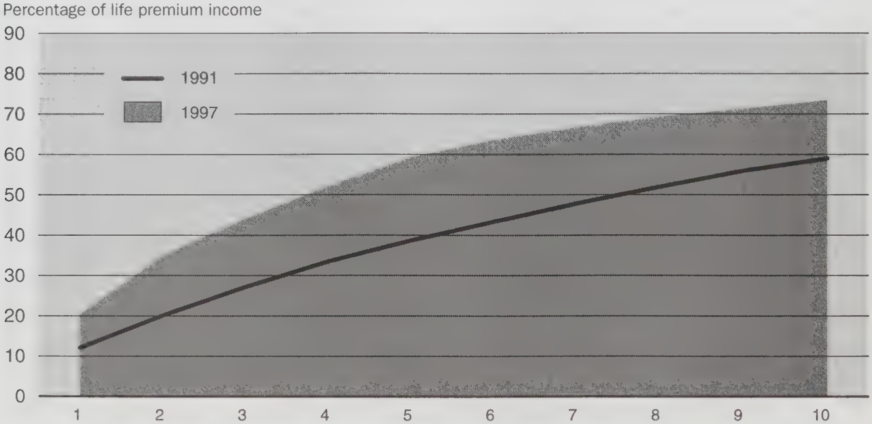
Percentage of direct premiums written. Excludes government-owned insurers.



Source: *Canadian Insurance.*

Exhibit 3.25
Cumulative Market Share
10 Largest Life Insurance Companies

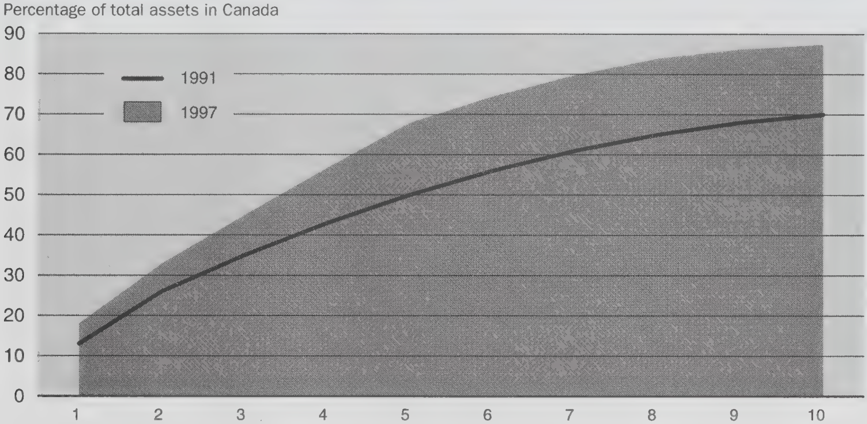
Percentage of life premium income



Note: 1997 data adjusted to reflect the following transactions: Great-West–London Life; Mutual–Met Life; Canada Life–Crown Life.

Source: *Canadian Insurance.*

Exhibit 3.26
Cumulative Market Share
10 Largest DTIs



Sources: Bank of Canada, OFSI, Annual Reports.

Consideration of these broad measures of institutional size gives only one perspective on markets in Canada. As illustrated earlier in this chapter, there are significant regional variations in the share of the large institutions. Also, since consumers typically choose a provider from all competitors offering a product rather than limiting their choices to particular types of institutions, market share in particular product markets is more relevant than the overall size of particular institutions.

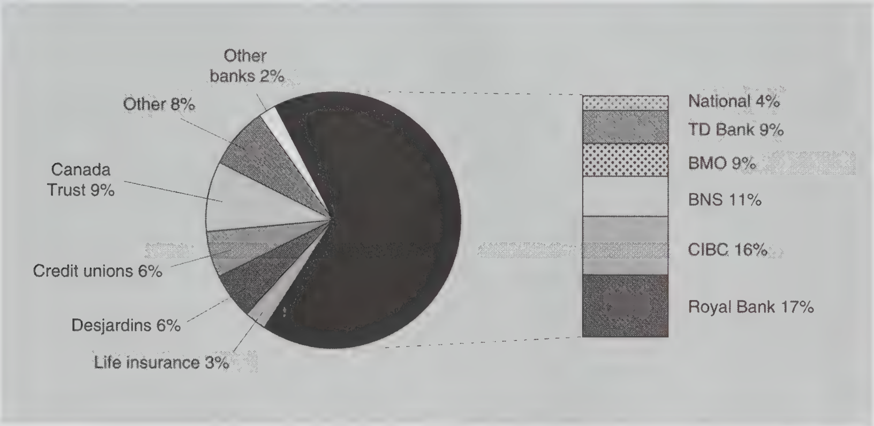
The consumer credit and residential mortgage markets illustrate that the largest firms in particular lines of business are not necessarily the largest institutions (see Exhibits 3.27 and 3.28). Canada Trust, although smaller than the five largest banks, has a much greater percentage of its business focussed on retail markets, and thus has a larger share of consumer credit and residential mortgages than its size might suggest.[53] As with deposits, the Quebec market for consumer credit and residential mortgages diverges significantly from the national picture. Desjardins and National Bank are the seventh- and eighth-largest providers of consumer credit on a national basis, but they are first and second in Quebec, with shares of 34.5 and 16 percent respectively within the province.[54] Similarly, the Alberta Treasury Branches has a significant share of

[53] Canada Trust's share of the mortgage market as measured by on-balance sheet mortgages, as in Exhibit 3.28, declined by almost half in 1997 as a result of securitization. However, measured on the basis of origination, Canada Trust has about 8 percent of the residential mortgage market.

[54] *En perspective*, Desjardins études économiques, March 1997.

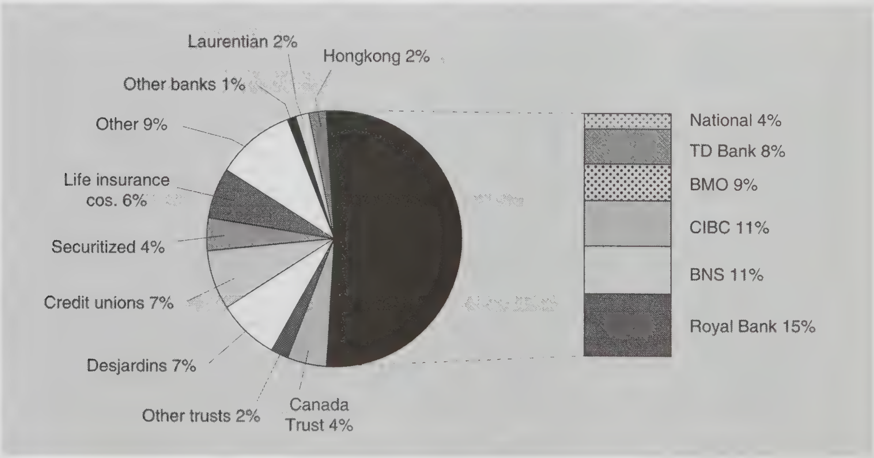
the Alberta market, and credit unions are major competitors in British Columbia, Saskatchewan, Manitoba and New Brunswick.

Exhibit 3.27
Consumer Credit in Canada, 1997
$138 billion



Sources: Total Market, Bank of Canada; Credit Union Central of Canada; Desjardins; 6 large institutions provided by the institutions or from detailed OSFI data, used by permission; others estimated from publicly available data.

Exhibit 3.28
Residential Mortgage Credit in Canada, 1997
$373 billion

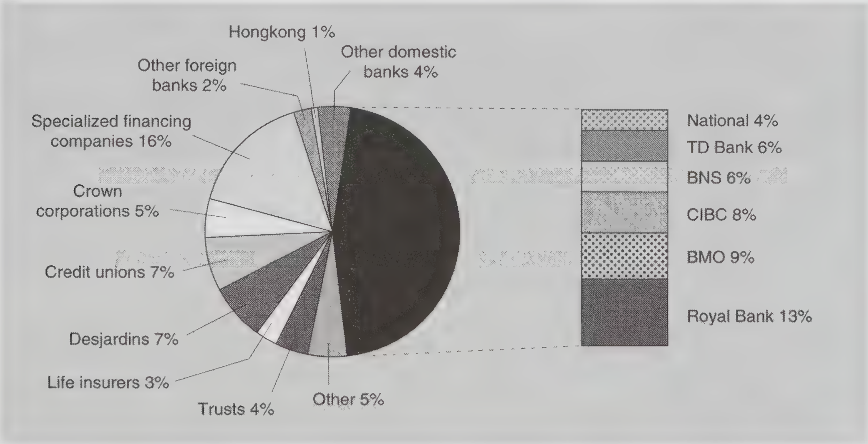


Sources: Bank of Canada E2; Credit Union Central of Canada; Desjardins; 6 large institutions provided by the institutions or from detailed OSFI data, used by permission; others estimated from publicly available data.

The Bank of Canada consumer credit data in Exhibit 3.27 understate the size of the market, and thus overstate the bank share because they do not include retail light vehicle leasing. Leasing of new vehicles in 1997 was a $35 billion business, with the financing arms of the major auto manufacturers having 70 to 80 percent of this market.[55]

As illustrated in Exhibit 3.29, there are also a significant number of non-bank competitors in the business financing market. However, these competitors generally do not offer products that compete with the banks in providing business banking accounts and working capital loans, with the result that there are relatively few alternatives to bank providers of small business transactions accounts and operating credit to finance receivables and inventory.[56]

Exhibit 3.29
SME Debt Financing in Canada, 1996
$110.9 billion



Sources: The Conference Board of Canada; Canadian Bankers Association, *Business Credit Statistics;* Credit Union Central of Canada.

[55] DesRosiers Automotive Consultants estimates that there was $35 billion in light vehicle leases (new vehicles only) outstanding in 1997. See DesRosiers, *Background Report on Extending Bank Powers to Include Light Vehicle Leasing*, Research Paper Prepared for the Task Force (Ottawa, September 1998).

[56] This point is raised in *Ending Power Without Accountability: Making Banks in Canada Better Before They Get Bigger*, Position Paper #6, a submission by the Canadian Community Reinvestment Coalition (Ottawa, May 1998). On page 5, it is argued that the bank share of business lending should be measured by the amount authorized rather than the amount outstanding. This approach overstates the bank share as the total market and share of all other players are only available on an outstanding basis. However, in the case of operating credit there are typically fluctuations in the amount outstanding, with the result that a significant difference is to be expected between authorized and outstanding. As the only real competition to the banks in the provision of operating credit comes from trust companies and credit unions, if data were available on operating credit authorizations that included banks, trust and credit unions, it could be expected to show a much larger bank share than the banks' share of total SME lending.

As with other markets, the small and medium-sized business market also has some significant variations (see Exhibit 3.30).

Exhibit 3.30
Regional Leaders in SME Financing
Value of Loans Under $1 Million Outstanding, 1997
($ millions)

Atlantic		**Quebec**		**Ontario**	
Royal Bank	1,035	Desjardins	10,640	Royal Bank	4,964
Bank of Nova Scotia	850	National Bank	3,533	Canadian Imperial Bank of Commerce	3,860
Bank of Montreal	585	Royal Bank	1,933	Bank of Montreal	3,220
Canadian Imperial Bank of Commerce	424	Bank of Montreal	1,462	Toronto-Dominion Bank	2,694
Credit unions	291	Business Development Bank	1,343	Bank of Nova Scotia	2,166
Man. & Sask.		**Alberta**		**B.C. + Terr.**	
Credit unions	3,129	Alberta Treasury Branches	1,915	Credit unions	2,839
Royal Bank	1,435	Royal Bank	1,717	Royal Bank	2,156
Farm Credit Corp.	1,360	Credit unions	989	Bank of Montreal	1,780
Bank of Montreal	688	Canadian Imperial Bank of Commerce	984	Canadian Imperial Bank of Commerce	1,356
Canadian Imperial Bank of Commerce	683	Bank of Montreal	971	Hongkong Bank	782

Notes: Hongkong Bank aggregates its Alberta and British Columbia statistics. The estimates for Alberta and British Columbia were determined by allocating the combined total loans under $1 million for those two provinces as disclosed in the CBA publication *Business Credit Statistics* proportionately to the number of branches of the bank in each province. Credit union data include all business and agricultural loans. This may slightly overstate credit union SME lending, but almost all credit union loans are less than $1 million. Desjardins estimates that 90 percent of its commercial loans and about 99 percent of agricultural loans are authorizations of less than $1 million. Alberta Treasury Branches includes independent business loans and all agricultural credit outstanding at March 31, 1998.

Sources: Canadian Bankers Association, *Business Credit Statistics*, September 1997; Farm Credit Corporation; Business Development Bank; Credit Union Central of Canada; Desjardins; Alberta Treasury Branches.

Outside of Ontario and Atlantic Canada, the leading providers of debt financing for small and medium-sized business are institutions other than the large banks. While the total business and agricultural credit extended by Desjardins, credit unions and the Alberta Treasury Branches is dwarfed by the banks, virtually all of the commercial loans extended by these non-bank lenders consist of authorizations of less than $1 million.

Profitability

Recently, there has been considerable public focus on financial sector profitability. Different definitions of the financial sector and different assumptions in allocating profits to Canadian and international activities yield somewhat varied results but tell a similar story. As illustrated in Exhibit 3.31, banks accounted for 45 percent (McKinsey) to 50 percent (Statistics Canada) of financial sector pre-tax profits earned in Canada in 1997.

Exhibit 3.31
Pre-Tax Profits Earned in Canada, 1997
($ billions)

	Banks	Life insurance	Retail and pension fund managers	Trusts, credit unions and caisses populaires	Other[1]	Total sector
McKinsey	8.6	2.4	2.4	1.8	3.7	18.9
Statistics Canada	8.3	2.3	N/A[2]	1.7	4.6	16.9

1 McKinsey's definition of "other" includes independent investment dealers and finance companies. Statistics Canada is residual (total financial sector excluding holding and investments companies, less the other three categories). The Statistics Canada definition of the financial sector includes financial intermediaries such as DTIs and life insurance companies, specialized financial corporations including financing subsidiaries of non-financial businesses, the property and casualty insurance industry, and market intermediaries such as agents and brokers. The largest component in the Statistics Canada residual is property and casualty insurance, $3.0 billion pre-tax profit in 1997.

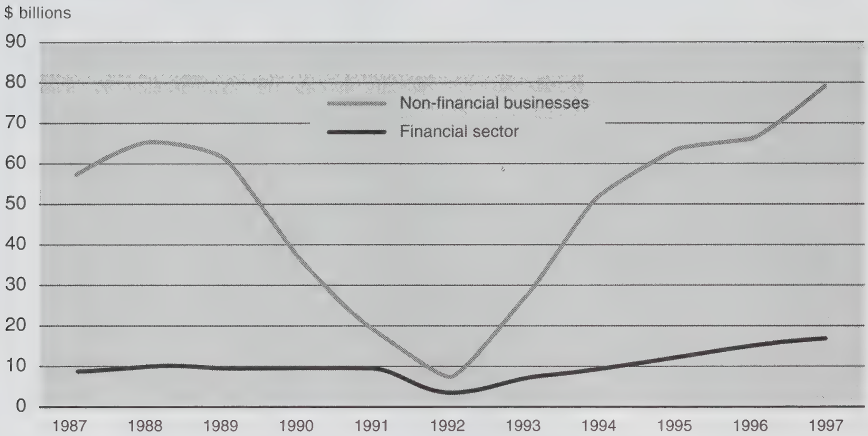
2 It is not possible to derive a comparable number to the McKinsey estimate from Statistics Canada data.

Sources: McKinsey, Exhibit 2.21; Statistics Canada, *Quarterly financial statistics for enterprises*, first quarter 1998.

The financial sector has experienced steady growth in profitability since 1992. The profitability of the non-financial sector of Canada's economy plunged much more dramatically during the early 1990s, but has since recovered at a faster rate (see Exhibit 3.32). Pre-tax profits of the non-financial sector are now about 20 percent above the pre-recession peak, with financial sector pre-tax profits about 70 percent above pre-recession levels. The financial sector accounted for about 21 percent of total corporate pre-tax profits in Canada in 1997, versus 15 percent in 1987. In addition to the record profits earned by Canada's banks and insurance companies, the high profitability of some other financial service players, such as specialized financing companies, has contributed to the growth in the financial sector's share of total profits. McKinsey estimates that chartered banks earned about 46 percent of all pre-tax profits in the Canadian personal financial services market in 1997, versus 47 percent in 1992 and 43.5 percent in 1987.[57]

57 McKinsey, *The Changing Landscape*, Exhibit 2.22.

Exhibit 3.32
Profit Before Tax



Source: CANSIM matrices D0086270, D0086183.

Conclusion

The banking and life insurance sectors in Canada are both highly concentrated in terms of market share, capital employed and profitability. The five largest banks account for over 85 percent of banking sector profits, and with the recent mergers in the life insurance sector, the five largest life insurance companies' share of the life sector's profits will likely begin to approach that of the five largest banks. While capital employed in the banking sector is about twice that of the life sector, the total net income of Canadian banks is about three times that of Canadian insurers. Definitive geographic profitability data are not available, but the five largest life insurance companies do half their business outside Canada, versus about one-third for the five largest banks, with the insurance industry earning a correspondingly higher share of its profits outside Canada.

A contributor to the higher profitability of domestic banking versus life insurance is the higher leverage of banks. The large mutual life insurance companies have capital amounting to 6 to 8 percent of total assets (including segregated funds), while Canadian banks have shareholders' equity in the range of 4 percent of assets. Also, as noted earlier in this chapter, banks have increasingly earned a larger portion of their profits from fee-for-service businesses, which typically require little capital in comparison to traditional lending.

The relative size of the largest financial institutions in Canada does make many markets difficult to contest in the short term. However, it is important to position this view of the financial services market in its historical context. Since the time of the MacMillan and Porter commissions, many new competitors have emerged and, as detailed in this chapter, are in fact among the market leaders in some regions and product markets. The Task Force believes that there is considerable room to further increase the number of competitors in the financial services sector, and has made proposals to both increase the potential for new entrants and to enhance the ability of existing smaller and mid-sized companies to compete vigorously with the largest institutions.

Chapter 4

Enhanced Competition for Canadians

Innovation and strong competition are the characteristics of a high-quality financial system, one that will best serve Canadians. It is beyond the powers of government to require innovation in financial services. However, it has the authority to shape the market environment within which competition and innovation can thrive.

Financial services are different from other sectors of the economy. Whether we are making a cash purchase, paying a bill by cheque, or accumulating wealth in a pension plan that grows through investments in domestic and global capital markets, financial services are an integral part of our lives as Canadians. The financial system is also essential to our economy. As a society, Canadians hold financial institutions to a higher standard of behaviour than other sectors. And Canadians rely on government regulation to ensure that important public policy objectives are maintained.

There is a tension created by the competing objectives of fostering competitive markets and ensuring a sound financial system. As noted in Chapter 1, an important challenge for governments is to establish a regulatory framework that balances these two objectives. The recent dramatic changes witnessed in financial services make this balancing exercise difficult.

Canada is not alone in facing this challenge. Governments worldwide are being forced to address similar types of financial regulatory issues. Yet no single regulatory model has emerged as the ideal approach. This is partly due to the fact that the evolution of financial services has taken place in quite different ways from country to country. Governments must adopt the regulatory model that best serves their country.

Canadians have enjoyed an efficient financial system, national pricing and reasonable access to service despite a challenging geography. Are these the right fundamentals for a financial system heading into the next century? Does the current regulatory model offer the appropriate balance between competition and other public policy goals?

This chapter examines:

- how well Canadians have been served by the financial services sector to date;
- how trends may impact the nature of competition in financial services over time and what this means for consumers; and
- what challenges to domestic competition are characteristic of a regulated sector such as financial services, and how those will be met.

The chapter concludes that more should be done to foster a competitive financial services marketplace. The Task Force proposes a four-point strategy intended to increase competition without sacrificing key public policy objectives of regulation. This strategy is fundamental to other policy proposals in this paper and to the recommendations of the Task Force.

Are Canadians Well Served?

As an advanced industrial economy, Canada has a highly developed financial sector providing efficient transaction services and both direct and indirect intermediation between lenders and borrowers. Hundreds of financial firms (not counting more than 2,000 individual credit unions and caisses populaires) are active in sectors ranging from traditional banking and insurance to sales finance, investment banking, fund management and specialized leasing. Business and product linkages throughout this system are complex, and multiple services are offered by some of these financial companies, depending on their expertise, the demands of their customers and government regulation.

Two approaches are taken in this chapter to assess the service levels provided by Canada's financial sector. The first is to benchmark them against measures of service levels and costs in other countries. The second is to report the results of several Canadian surveys of business and consumer groups, including a public opinion survey performed for the Task Force by Ekos Research Associates.

The international benchmarking exercise indicates that, compared with most other countries, Canadians receive reasonably good – but not top – value and service from their institutions. The Ekos opinion survey and group interviews indicated a mixed picture: while most individuals were generally satisfied in their day-to-day dealings with financial institutions and appreciated the benefits of technology, there were concerns about erosion of competition and a deterioration of service levels.[58]

[58] Ekos Research, *Public Opinion Research Relating to the Financial Services Sector*, Research Paper Prepared for the Task Force (Ottawa, September 1998).

Global Competitiveness Survey

In its 1997 Global Competitiveness survey, the World Economic Forum ranked Canada fifth overall in terms of the competitiveness of its financial services sector.[59] Exhibit 4.1 shows the performance rankings, many of which relate to service levels. U.S. rankings are also shown for comparison.

Exhibit 4.1

Canadian Financial Sector Global Competitiveness Rankings

Characteristic	Canada's rank	U.S. rank
Degree of overall sophistication	4	2
Supply of venture capital	5	1
Degree of competition from foreign banks	41	10
Soundness of banking system	1	15
Low loan-deposit interest rate spreads	7	3
Stock markets as good source of capital	2	1
Well-developed bond market	2	3
Adequacy of regulation	2	10
Ease of entry into the banking industry	39	10
Market-determined interest rates	7	13

Source: World Economic Forum, *The Global Competitiveness Report* 1997. The rankings are the result of a worldwide survey of executives' opinions on 53 countries.

Canada ranks high in many areas, especially in soundness of the banking system, where it is ranked first. Research conducted by McKinsey & Company for the Task Force notes that, over the last 15 years, the failure of federally regulated institutions has cost Canadians far less proportionately than similar failures south of the border have cost U.S. taxpayers.[60] Canada's markets (stock and bond) and the regulatory environment are ranked favourably. However, what is striking in the survey is Canada's relatively low rankings with respect to foreign bank competition (41st) and ease of entry into the banking industry (39th). The rankings of these two characteristics taken together reflect a traditional Canadian propensity for safety and soundness, and the protection historically afforded to major parts of the financial services sector.

[59] World Economic Forum, *The Global Competitiveness Report* (Geneva, 1997).

[60] McKinsey & Company, *The Changing Landscape for Canadian Financial Services*, p. 68, estimates that failures have cost CDIC $3.1 billion, while in the United States failures have cost US$192.1 billion.

Although Canada scores high compared with a broad spectrum of countries, we often rank behind the scores given to our largest trading and financial partner. Given the close historical linkages of the North American economies and the new impetus provided by regional free trade agreements, such rankings relative to the United States are important.

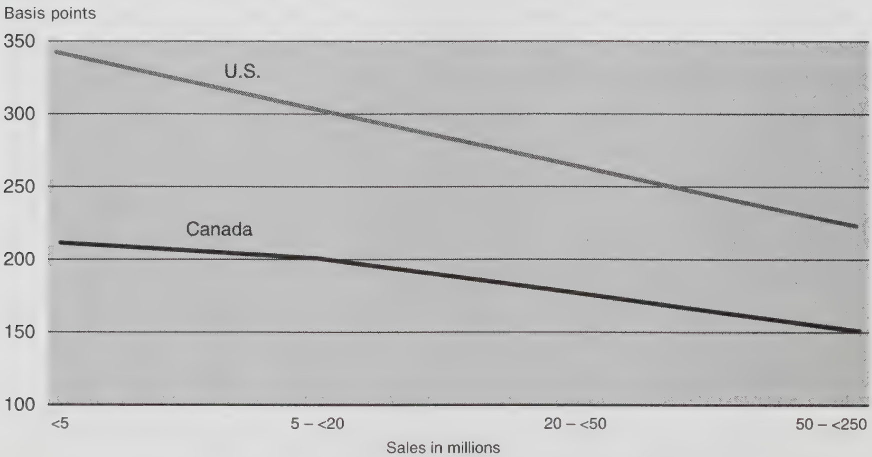
It should be stressed that these rankings are not based on objective data but rather on opinions of executives from around the world. They are nevertheless important indications of how our system is perceived by trading partners and potential investors.

From this general overview of service performance, the chapter turns to an analysis of the efficiency of intermediation in Canada. Next, service levels for large and small business and for consumers are examined, both through market indicators and by means of a number of opinion surveys.

Efficiency of Intermediation: Loan-Deposit Spreads

The difference between interest rates on loans and on deposits (the loan-deposit spread) is one way of measuring the efficiency of intermediation performed by financial institutions – the cost of the intermediation service. As the following charts in Exhibits 4.2, 4.3 and 4.4 show, Canadian spreads are quite low relative to other countries. This suggests that financial intermediation is being performed efficiently compared with other countries, including the

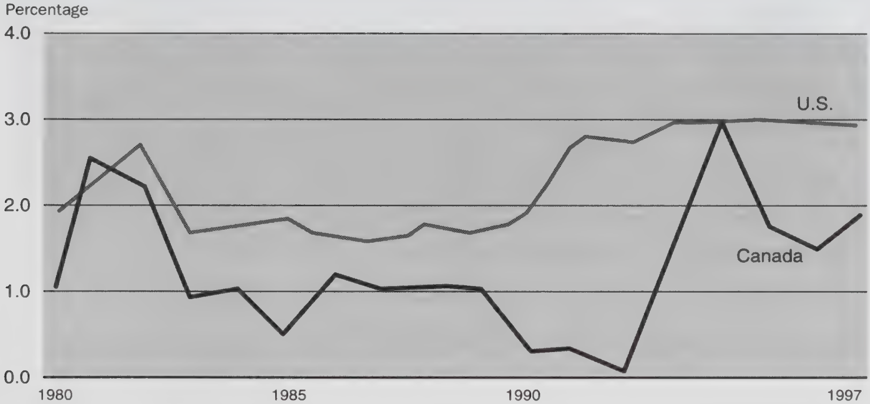
Exhibit 4.2
Interest Rate Spreads by Size of Borrower (Canada and U.S.)
Spread Over Cost of Funds, August 1996



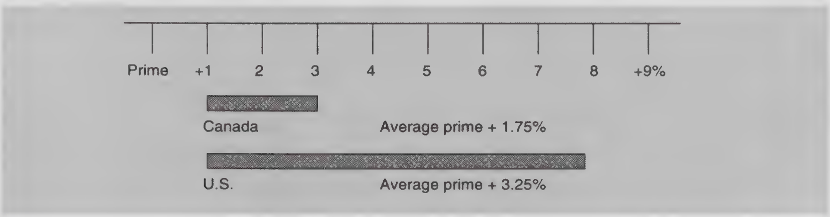
Sources: McKinsey & Company; Loan Pricing Corporation.

United States.[61] Other observers, including the International Monetary Fund, have also noted the relatively low intermediation spreads in Canada relative to other countries, which have persisted over a number of years.[62] However, a notable exception is credit card spreads (shown later in the section on individual consumers).

Exhibit 4.3
Interest Rate Spreads (Canada and U.S.)
Spread Between Prime and Benchmark Rate (Bank of Canada Rate and Equivalent U.S. Rate)



Range of Interest Rates

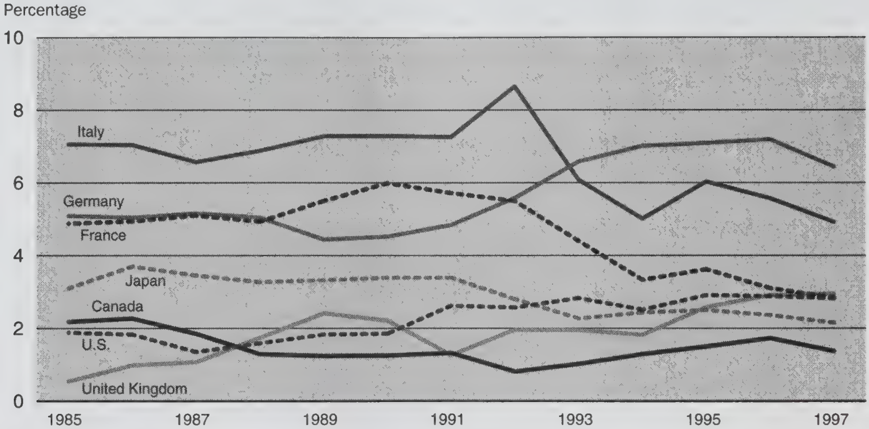


Sources: McKinsey & Company; Bank of Canada; Federal Reserve Board; Wells Fargo; CFIB; CBA.

61 In Exhibit 4.1, Canada is ranked behind the United States in loan-deposit spreads. The inconsistency with the reported data is because of the nature of the Global Competitiveness survey, which records the opinions of respondents. In fact, the same survey, in its collection of data on interest rate spreads, confirms the low Canadian spreads (lower than the United States) reported in this paper. Some of the difference may relate to more visible pricing for risk in the United States in certain areas of credit, but it is hard to argue this across the whole lending spectrum (large business loans, consumer credit and mortgages). Market size and depth, and the choice of financial institutions and instruments may also affect the perceptions of spreads.

62 International Monetary Fund, *Capital Markets Report*, 1997; Annex 3, "Developments in International Banking," p. 148.

Exhibit 4.4
Major Industrial Countries: Interest Rate Spreads
Lending Rate Minus Average Deposit Interest Rate



Sources: IMF, *International Financial Statistics.*

As noted in the submission to the Task Force by Power Financial Corporation,[63] it is also worth examining what has happened to spreads over time as the financial services sector has consolidated. Such data, shown in Exhibit 4.4, reveal that spreads in Canada have widened somewhat over the 1990s but still remain below levels in most countries.

Financial Services and Customer Segments

1. Larger Canadian Businesses

Larger corporations in Canada have a variety of sources of finance, and foreign investment banks have made inroads into the Canadian market with attractive pricing and innovative products for them. Capital market costs and liquidity are important to large corporations, since these markets are accessed regularly as sources of finance. Exhibit 4.5 indicates that for raising new funds in debt and equity markets, the costs for new issues in Canada are just above those in the United States, arguably the world's most efficient capital market. As already mentioned, loan-deposit spreads are also favourable in Canada.

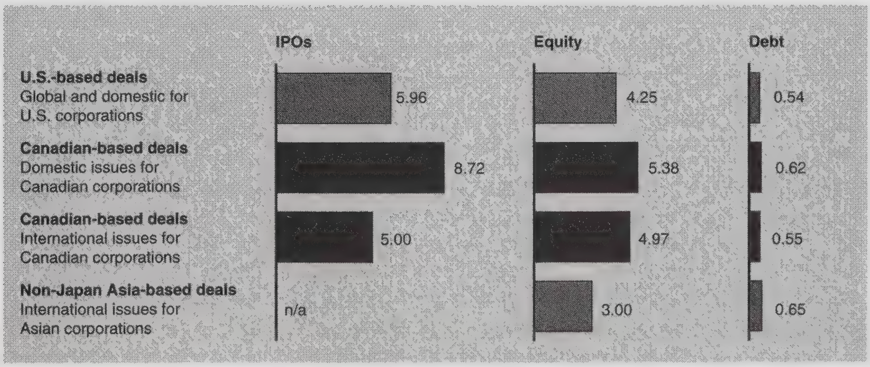
A Conference Board report on corporate banking relationships in Canada prepared for the Task Force concluded the following:

[63] Power Financial Corporation, *Submission to Task Force* (November 1997), pp. 21, 22.

- The traditional one-on-one relationship between the large corporation and its banker no longer exists. Corporations maintain business relationships with a number of banks and choose them on the basis of the products and services in which they are competitive. Some elements of a large Canadian corporation's banking may be done outside Canada.
- Canadian banks continue to dominate the corporate banking market in Canada, but subsidiaries of foreign banks in Canada have made inroads in certain areas, for example in the provision of innovative financial risk management products (swaps, options, etc.).
- Some Canadian business groups found Canadian banks operating in the United States to be competitive with local banks there.
- For international business, local banks operating in their home markets were seen as providing better service than Canadian banks.
- While regarded as stable and reliable, Canadian banks are seen to be slow to introduce new technology and innovative products. This is consistent with the market share gains observed for foreign banks for certain products.[64]

Exhibit 4.5
Underwriting Costs

Percentage of issue amount



Sources: McKinsey & Company; The Financial Post database; Investment Dealers' Digest.

64 Hugh Williams, The Conference Board of Canada, *Corporate Banking Relationships in Canada: The CFO View,* Research Paper Prepared for the Task Force (Ottawa, September 1998).

2. Small and Medium-Sized Businesses

For small and medium-sized business, services provided by deposit and lending institutions, financial product pricing and choice are not as attractive as for large business. Although the financing of small and medium-sized businesses is discussed in some detail in Background Paper #4, *Canadians' Expectations and Corporate Conduct*, a few highlights are reported here.

Monthly business banking fees for small business in Canada are average relative to a group of countries. A survey conducted by McKinsey & Company found that, for a typical current account pattern of usage for a small business, monthly fees ranged from $8 in some European countries to $27 in the United States and Australia, with Canada coming in at $18.[65] Yet, in a 1997 survey, the Canadian Federation of Independent Business (CFIB) notes that service fees have become the most frequent banking complaint, a finding confirmed in a survey conducted by Thompson Lightstone & Company.[66] These results led McKinsey & Company to conclude: "There are gaps between SMEs' expectations and the quality of service delivered by Canadian institutions."[67]

The availability of small business credit has been a continuing focus of debate in Canada. The CFIB notes some improvement in the availability of credit in its 1997 survey but describes a continuing credit shortage among the smallest businesses. While loan-deposit spreads appear low, as noted above, evidence supports the view that Canadian deposit-taking institutions are more risk-averse than others and, in addition, do not price appropriately for higher levels of credit risk[68] or the higher costs of monitoring. Thus, posted loan rates may appear lower in Canada than in other countries (particularly the United States) because higher-risk borrowers in Canada are simply not granted loans. McKinsey notes:

> Most SME loans in Canada are priced between prime and prime plus 3 percent, with an average of prime plus 1.75 percent. In the United States, this range is much broader, and loans can be priced anywhere from prime to prime plus 8 percent, with an average of prime plus 3.25 percent. The narrower range in Canada may imply that Canadian banks are not adequately pricing for risk, which may have implications for SME accessibility.[69]

[65] McKinsey, *The Changing Landscape*, pp. 62, 63.

[66] Canadian Federation of Independent Business, *CFIB Research: The Price Is Not Right*, December 1997, p. 1. Thompson Lightstone & Company, *Small and Medium Sized Businesses in Canada: An Ongoing Perspective of their Needs, Expectations, and Satisfaction with Financial Institutions*, Vol. One (Toronto: CBA, 1997), p. 102.

[67] McKinsey, *The Changing Landscape*, p. 63.

[68] Allan Riding, "On the Care and Nurture of Loan Guarantee Programs," in ed. Paul Halpern, *Financing Growth in Canada* (Univeristy of Calgary Press, 1997), p. 642.

[69] McKinsey, *The Changing Landscape*, p. 62.

The formation of labour-sponsored venture capital funds has injected a considerable volume of money into the venture (private equity) capital market, a key financing field for small business. However, such institutional sources tend not to offer seed and start-up capital for the smallest firms, which are the most risky. Instead these needs are served by a fragmented and imperfect market.[70]

With respect to the overall quality of banking services for small business, the Canadian Federation of Independent Business notes that member satisfaction has been historically in the 70 percent range, a finding that is consistent with the Thompson Lightstone survey. The CFIB comments that while this rate appears high, in fact it indicates a significant degree of dissatisfaction.[71] Lower rates of satisfaction were noted both in the Thompson Lightstone study and by the CFIB when specific aspects of service, costs and credit availability were probed.

3. Individual Consumers

Individuals use a wide variety of financial services ranging from investing, borrowing and transactions-based services to insurance and asset management. Canadian firms are active in serving all of these demands. This section examines the service levels in these areas and concludes that, by and large, Canadians receive good service at reasonable cost.

In the consumer loan and mortgage markets, interest rate spreads relative to those in a group of industrial countries indicate that, as in the overall loan spread analysis, the financial system is channelling funds to borrowers efficiently (see Exhibits 4.6 and 4.7). Canada ranks second in each of the charts.

However, as shown in Exhibit 4.8, credit card interest spreads and fees are significantly higher in Canada than in the United States. This may reflect the restructuring that has occurred in the latter market with the advent of the specialized credit card service providers such as MBNA and Capital One. Through economies of scale in transaction processing and securitization techniques applied to outstanding credit card loans, these firms have lowered the costs of credit card services to consumers and so have gained market share.

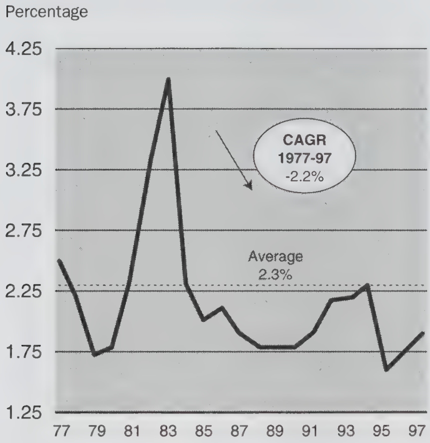
Another aspect of service to individuals is the cost, efficiency and availability of transactions services. On behalf of the Task Force, McKinsey & Company designed and conducted a cross-country survey of prices and service costs for personal payments transactions. The survey was structured to take account of the different mix of payment mechanisms (cheques, point-of-sale and bank machine transactions). Canadian institutions were shown to be near the

70 See Background Paper #4.

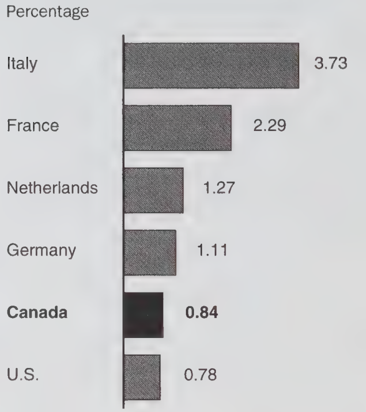
71 Canadian Federation of Independent Business, *Submission to the Task Force on the Future of the Canadian Financial Services Sector*, October 1997, p. ii. Thompson Lightstone, *Small and Medium Sized Businesses*, (1997), p. 97.

Exhibit 4.6
Interest Rate Spreads: Mortgages

5-Year Mortgage Spreads Have Declined Over the Past 20 Years



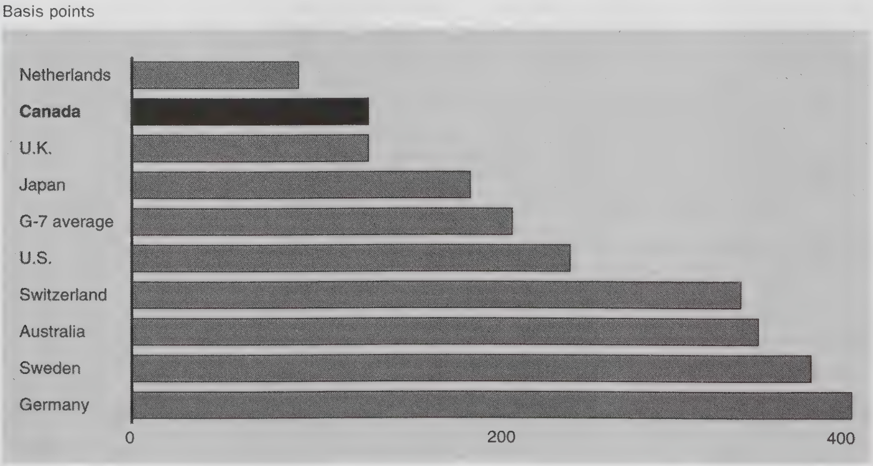
On Average, 1-Year Mortgage[1] Spreads Are Lower in Canada than in Europe



[1]Or equivalent

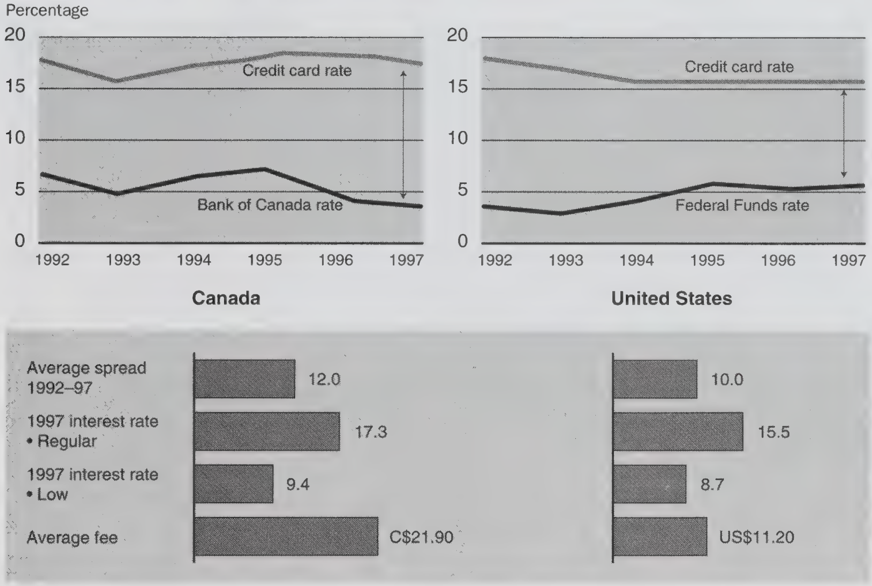
Sources: Bank of Canada; McKinsey & Company analysis.

Exhibit 4.7
Interest Rate Spreads: Personal Loans
Average Consumer Loan Rate Minus Market Rate, 1990–96



Sources: McKinsey & Company; *An Assessment of Financial Reform,* OECD; International Monetary Fund; International Financial Statistics.

Exhibit 4.8
Credit Card Interest Rates Spreads and Fees



Sources: McKinsey & Company; Industry Canada; Federal Reserve.

middle of the range of industrial countries (as shown in Exhibit 4.9) in what they charge for personal banking service packages. The average U.S. charge for such services is more than 50 percent higher than in Canada.

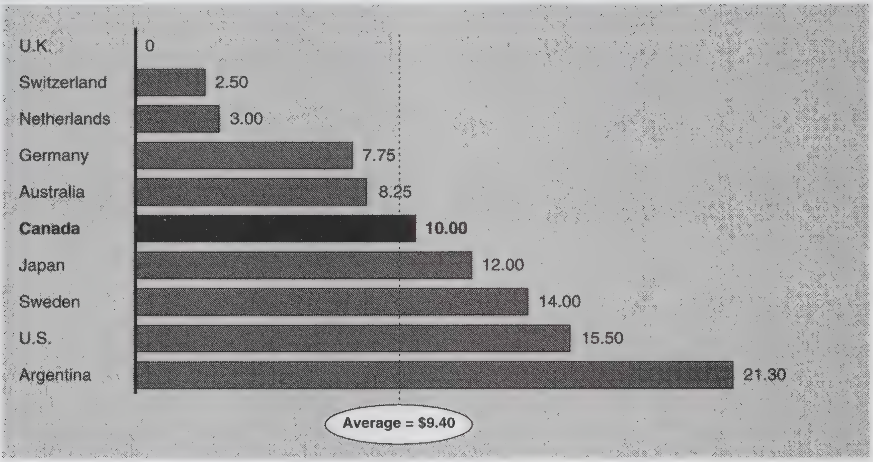
The availability of payments services in Canada appears good compared to other countries. The number of ATMs per person is second-highest in the OECD, and the number of point-of-sale (POS) terminals per person is third-highest (see Exhibit 4.10).

The Canadian payments system is very efficient. Cheques clear in about a day, faster than in most national clearing systems (see Exhibit 4.11). This provides an advantage to transactors, as recipients of funds receive credit sooner and there is relatively less float in the banking system. Canada's national financial institutions price services at a national level and do not differentiate by region, a feature of the system not characteristic of countries with a larger number of regional institutions.

Exhibit 4.9

Average Monthly Service Fees[1]

C$



[1]Based on adaptation of Industry Canada's definition of 8 cheques per month, 6 POS transactions, 5 ATM transactions, and a minimum balance <$1,000.

Source: McKinsey & Company International F.I. service fee comparison.

Exhibit 4.10

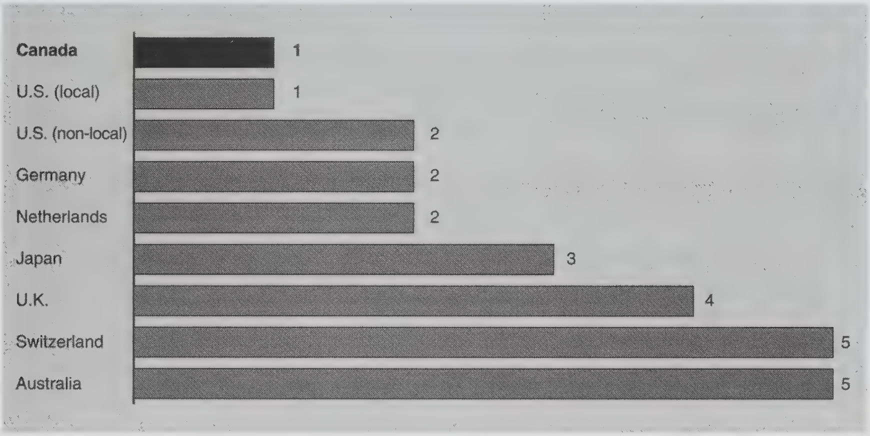
Banking Distribution Networks

ATMs ranking Number of machines per 10,000 inhabitants, 1996		**POS ranking** Number of terminals per 10,000 inhabitants, 1996	
1. Japan	10.51	1. U.K.	93.54
2. Canada	**6.17**	2. France	93.33
3. U.K.	5.85	**3. Canada**	**84.08**
4. U.S.	5.24	4. Belgium	79.97
5. Germany	4.59	5. Sweden	75.79

Sources: McKinsey and Company; BIS survey of OECD countries.

Exhibit 4.11
Cheque Clearing

Number of days to clear cheques, 1996



Sources: BIS; J.M. Lacker, *The Check Float Puzzle;* McKinsey analysis.

Technology has on balance improved the access of Canadians, particularly in remote locations, to some aspects of banking services. In addition to banking machines, improvements in communications technology have enabled basic banking services to be conducted in some stores and post offices.[72] Some telephone banking functions are available via 1-800 lines 24 hours a day, seven days a week. As discussed in Chapter 5, Canada's retail banking services are as efficient and as technically advanced as those of other industrial countries.

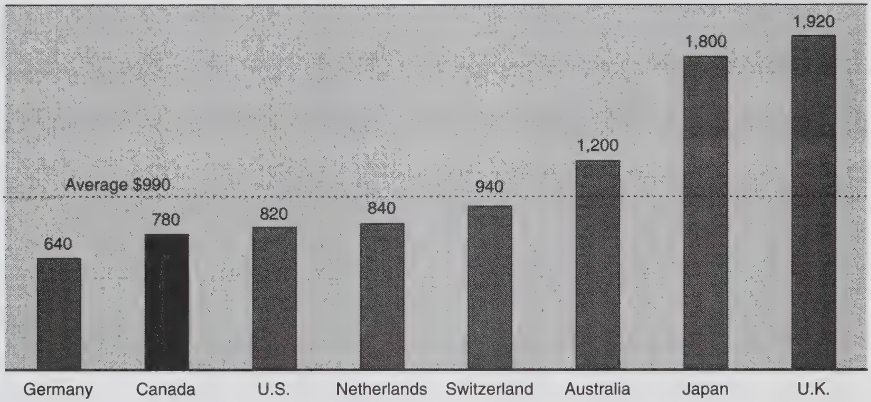
In Canada, 131 Canadian and foreign life insurance companies offer a variety of products to Canadians. Life insurance premium rates are just below the average for a group of eight industrial countries (see Exhibit 4.12), a finding consistent with the good international competitive position of this sector, as discussed in Chapter 5. However, there is a need to improve disclosure regarding insurance products, as indicated in the Ekos Research public opinion survey conducted for the Task Force and in the brief to the Task Force presented by the Independent Life Insurance Brokers.[73]

72 Bank of Montreal and Canada Post announced plans to roll out 20 bank branches in postal outlets located in remote communities. As a result of a pilot project in Labrador, 210 of 260 households opened basic banking accounts in the postal branch at a set monthly fee. Bank of Montreal, news release, "Bank of Montreal and Canada Post to Provide Banking Facilities to Remote Communities across Canada," Toronto, June 2, 1998.

73 Ekos Research, *Public Opinion Research*, Ch. 8. Independent Life Insurance Brokers of Canada, *Submission to the Task Force on the Future of the Canadian Financial Services Sector: Life Insurance Distribution by the Independent Life-Licensed Broker* (November 1997).

Exhibit 4.12
Life Insurance Annual Premiums[1]

C$



[1] For a 5-year term policy for a 35- to 45-year-old male non-smoker insured for $100,000.

Sources: McKinsey & Company Global FIG Practice; interviews.

The rapid growth in the number of mutual funds, the variety of investment styles followed by the funds, and the entry of many leading foreign asset management firms into the Canadian mutual fund industry have given Canadians an unprecedented choice of products. Mutual fund administration fees, however, are higher in Canada than in the United States, because of the smaller scale of operations in Canada, higher penetration of low-cost passive index funds in the United States and more advice-intensive distribution channels in Canada.[74]

In the securities and brokerage industry, the proliferation of discount brokerages has reduced the cost of commissions for individuals. The institution of decimal pricing on the Toronto Stock Exchange appears to have reduced bid-ask spreads, at least for many of the more liquid stocks. New forms of computer-based order entry through discount brokers offer very low-cost stock trades for individual consumers. The abandonment of fixed brokerage commission schedules in the early 1980s and then the introduction of discount brokerages contributed to the reduction in commission costs. In spite of the dominance of the industry's assets by banks, the number of member firms of the Investment Dealers Association has risen over the last decade, suggesting that there remains a considerable degree of choice for clients in terms of service levels in the brokerage industry.

[74] McKinsey, *The Changing Landscape*, Exhibit 6.31.

Canadian Opinion

A public opinion survey conducted by Ekos Research Associates for the Task Force indicates that a very large proportion of Canadians are satisfied with their financial institutions.[75] Respondents perceived the degree of competition in banking and insurance as adequate, but ranked insurance ahead of banking in that respect.[76] Particular concerns appear to exist in the following areas:

- handling of complaints;
- tied selling;
- privacy;
- disclosure;
- comfort with new technologies; and
- public responsibilities of the financial sector.

These issues are addressed in Background Paper #3, *Empowering Consumers* and Background Paper #4, *Canadians' Expectations and Corporate Conduct.*

In a survey by the Public Interest Advocacy Centre (PIAC) and the Consumers' Association of Canada (CAC), 62 percent of respondents said there is currently enough competition in the banking sector to protect their interests,[77] a result generally consistent with the Ekos survey. However, these numbers vary significantly across Canada. Seventy-five percent of people living in Quebec felt there was enough competition, possibly because of the presence of the Mouvement Desjardins in addition to the major banks. In contrast, only 54 percent of Ontarians felt there was enough competition. Banks received the same rating as retail gasoline dealers in terms of overall competition (4.8 average on a 7-point scale). Insurance companies rated higher at 5.1, along with airline companies. Both banks and insurance companies rated lower than investment dealers (5.4) and telephone companies (5.5).[78]

Ekos reports that 11 percent of Canadians expressed dissatisfaction in their last dealing with a deposit-taking institution. This is consistent with research by Goldfarb Consultants which found the following levels of overall dissatisfaction with service: 9 percent for banks, 8 percent for trust companies,

[75] Ekos Research, *Public Opinion Research*, Chapter 4.

[76] Ibid., pp. 44-46.

[77] Public Interest Advocacy Centre and the Consumers' Association of Canada, *Banking on Consumer Power: The Issues for a Canadian Consumer Coalition for the Banking Industry* (Ottawa, February 1998), p. 85.

[78] Ekos Research, *Public Opinion Research*, p. 45.

6 percent for credit unions and 7 percent for caisses populaires.[79] Twelve percent were dissatisfied in their last dealings with an insurance company or broker.[80]

When problems exist, they do not appear to be resolved very quickly or satisfactorily. Nine percent of Canadians reported having a "serious problem" with their banking institution in the past year, and a significant number of those attributed the problem to a "mistake" on the part of the financial institution. Less than half of these problems (46 percent) were reported to have been fully resolved, and 36 percent were not resolved at all. Seven percent of Canadians reported having similar problems with an insurance company or broker. Only 30 percent of those problems were fully resolved, and 50 percent were not resolved at all.[81]

Canadians also appear to be concerned about the terms and conditions of their financial contracts. A surprisingly high percentage of Canadians (16 percent) reported feeling that their loan or mortgage might not have been approved if they had not purchased another product from the same institution.[82] Sixty-four percent of Canadians think they are not receiving enough information about the banking products they are purchasing. The number is similar (68 percent) for products bought from insurance companies.[83] Canadians have strong concerns about privacy but are split on whether their privacy rights are adequately protected.[84]

On the question of safety and soundness, half of Canadians (49 percent) appear to have more confidence in the banking sector compared with 10 years ago, although 23 percent indicate they have less confidence. Only 10 percent of Canadians feel that a large Canadian bank will fail in the next 10 years. Eighteen percent feel the same is true of a large insurance company. In respect of credit unions and large mutual fund companies, 21 and 22 percent, respectively, believe there will be such a failure. Trust companies and smaller banks are viewed as most at risk, with 30 percent of Canadians believing one will fail in the next 10 years.[85] Only 6 percent of Canadians report having had direct exposure to a failed financial institution.[86]

[79] *The Goldfarb Report 1997: Financial Tools and Institutions*, Sector Book 8 (Toronto: Goldfarb Consultants), p. 17.

[80] Ekos, *Public Opinion Research*, pp. 28-36.

[81] Ibid., pp. 31-36.

[82] Ibid., pp. 54, 55.

[83] Ibid., pp. 53, 54.

[84] Ibid., pp. 58, 59.

[85] Ibid., pp. 37, 38.

[86] Ekos Research, prepared for Canada Deposit Insurance Corporation, *Public Awareness Research in Support of CDIC Information By-Law Changes: Final Report* (Ottawa, July 25, 1997), p. 37.

Canadians have mixed attitudes about banks. Canadians see banks as good corporate citizens (44 percent agree, 28 percent disagree) and responsible employers (46 percent agree, 22 percent disagree), but consider them heartless (44 percent) rather than caring (28 percent).[87] Canadians are also much more likely to trust the bank manager at a local branch than the president or CEO of large banks.[88] The negative attitude of Canadians toward banks appears to be linked to such factors as service fees, profits and the perceived power and influence of banks.[89]

This mixed perception of banks may be related to the strong belief among Canadians that banks have a greater responsibility to the public than other sectors.[90] This reflects the view that banks play an important role in Canadian society. Ninety-four percent of Canadians feel that it is necessary for an individual to have a savings or chequing account. Over half (51 percent) feel this is "absolutely necessary."[91] Interestingly, 69 percent of Canadians agreed with the view that banks should not lay off more people even if it means that service fees will not be the absolute lowest. Some of the negativity may reflect a perception that banks are not living up to their greater responsibility. For example, 49 percent of Canadians believe that banks do not do enough for small business and self-employed people.[92]

The results of the qualitative research conducted by Ekos as part of its study shed some light on the mixed views of Canadians about banks. The research suggests that Canadians see bank profits as deriving largely from the money of depositors. Accordingly, there may be a sense that Canadians have a stake in the success of banks that they do not see being rewarded through better service or lower prices. This may, in part, explain why Canadians place a greater burden of public responsibility on banks, why they are more hostile toward bank profits, and why they view service charges as particularly unfair.[93]

87 Ekos Research, *Public Opinion Research*, pp. 40, 41.

88 Ibid., pp. 38, 39.

89 Ibid., pp. 60-62.

90 Fifty-eight percent of Canadians feel that banks have greater public responsibilities than other businesses. Ibid., p. 41.

91 PIAC and CAC, *Banking on Consumer Power*, p. 82.

92 Ibid., p. 87.

93 Ekos Research, *Public Opinion Research*, pp. 33, 41 and 42.

Summary of Observations

Although by many measures Canadian consumers of financial services appear to be well served, there continues to be a gap between the quality of service expected of financial institutions and that delivered. On the one hand, the wholesale financial services markets have access to world-class products and services both inside and outside of Canada as a result of globalization. Individuals generally enjoy attractive pricing on retail financial services, an expanding range of choices among providers and world-class convenience of access. However, complaints about the quality of service and fewer competitors for some products may be justified. Smaller businesses receive "fair to slightly below fair service" in terms of pricing, quality, choice and accessibility, with access to credit remaining as a challenge in the absence of a developed non-bank, sub-prime lending market.[94] The problems comsumers experience are real, which suggest that the hallmarks of innovation and strong competition identified earlier are not fully embedded in all aspects of the Canadian financial services sector.

Challenges to Domestic Competition in Financial Services

Competition is a powerful disciplining force. Companies that fail to remain efficient, provide value to customers and adjust to their changing competitive environment risk being displaced by new and innovative firms. Companies in the financial services sector are no exception.

Although competition is desirable in the financial services market, it is not assured. In fact, certain characteristics of the financial services market pose particular challenges to the objective of domestic competition. These include the following:

- *Barriers to entry.* Financial sector regulation, particularly rules aimed at ensuring the safety and soundness of the financial system, can deter new competitors and limit competition. Other barriers stem from the entrenched position of the incumbents, such as the banks, with their extensive branch networks and very strong brand recognition.
- *Information asymmetries.* Financial services products are often complex, and their terms and conditions are not transparent. Consumers can shop around and move their business, but it is not easy or without cost.
- *Industry consolidation.* Ongoing industry restructuring can result in fewer competitors and less choice for consumers.

These three competition challenges are compounded by the rapid pace of change taking place in the sector. They are discussed in greater detail below.

[94] McKinsey, *The Changing Landscape*, p. 19.

Barriers to Entry

A competitive industry is dynamic. If existing firms fail to innovate and provide value for their customers, new firms will enter the market and take market share. A competitive industry is usually characterized by new entrants and the exit of uncompetitive firms.

A market which is relatively easy to enter and exit is considered "contestable." Not all markets are contestable. Those which are not have barriers to entry that make it difficult for new firms to compete, thus providing incumbent firms with some protection from competitive pressures.

Barriers to entry may take a variety of forms. In financial services, for example, the existence of extensive national branch networks has acted as an economic barrier to entry which has discouraged most foreign banks from competing with the biggest Canadian banks. The challenges of finding, leasing, and fitting up good locations, hiring and training staff, setting up branch operating systems and advertising services is simply too great. The reluctance of customers to change institutions and strong brand identities of banks may also be barriers that make it difficult for new financial institutions to win market share.[95] These are examples of economic barriers to entry.

Globalization, the innovative application of technology and changing consumer demands are constantly lowering the economic barriers to entry. For example, the development of electronic distribution channels is lowering the cost of entry in banking. As a result, there are new entrants such as ING, Citizens Bank and Loblaws in the banking services markets. In effect, such new entrants can leapfrog the incumbents and, if successful, convert the banks' traditional branch network from a benefit to a burden.

Regulation can also create barriers to entry affecting the extent and nature of competition in financial services. For example, minimum capital requirements, "fit and proper" management tests, restrictions on the activities of financial institutions, ownership rules and the application approval process can all increase the cost of set-up and potentially reduce the range of candidates qualified to become competitors.

The forces of change appear to have had less impact on regulatory barriers to entry. As economic barriers to entry fall, regulatory barriers become more prominent. The potential for more competition and greater benefits to consumers brought about by the forces of change may not be fully realized if regulation continues to serve as a significant barrier to entry.

[95] McKinsey reports that no bank has been able to move its market share by more than a percentage point in a year other than through acquisition. McKinsey, *The Changing Landscape*, p. 45.

Information Asymmetries

A demanding consumer is a disciplining force in markets. The wholesale market for financial services provides a good example of the impact of a customer segment that has relative bargaining power. The fierce competition and low margins in the wholesale sector are partially attributable to a customer segment that is aware of its competitive options and is willing and able to shift its business at any time.

At the heart of a strong consumer segment is information. Customers that have ready access to information on competitive alternatives, including information on pricing, risk, and product and service quality, are more challenging to satisfy. One difficulty for the retail customer has been access to information. This contrasts with the level of information available to financial institutions, which have better access to information about competitors, about product features and even about the consumers themselves. The ability to use this information gives financial institutions an advantage which reduces the ability of consumers to act as a disciplining, competitive force.

Take a basic banking account as an example. The fee structures may make it extremely difficult for a customer to determine which of two competing products is more favourable. The financial institution has an information advantage, because it knows precisely what fees a particular account will generate, on average, over a set period. Similarly for insurance, the various limitations and features of an insurance contract may make it difficult for a customer to understand the overall value of the insurance compared with a competing product.

Technology is changing this situation. Technology makes more information available to consumers more quickly and at lower cost, thereby reducing the asymmetries. Industry Canada's Internet site, "Strategis," allows consumers to compare the costs of bank accounts offered by different financial institutions based on typical account usage.[96] Strategis offers a similar comparison service for credit cards. Internet "integrators" such as I|Money, Intuit and Insurance Quote provide access to comparison services that allow customers to compare prices across institutions.

[96] The Internet address for Strategis is strategis.ic.gc.ca.

Industry Consolidation

The forces of change are prompting an unprecedented consolidation trend in financial services. This increasing concentration in financial markets poses a serious challenge from a competition standpoint. Industry restructuring brings about efficiencies which can be passed on to Canadians. However, if the impact of consolidation is less competition, this can be detrimental to Canadian interests.

This section examines some analytical issues associated with the impact of consolidation on competition. Policy issues are discussed in Chapters 6 and 7.

1. Competition Law

In Canada, competition laws exist for the purpose of preventing individual firms or groups of firms from engaging in activities which will seriously harm competition. Although competition laws apply to the financial services sector in much the same way as they apply to other industries, it should be recognized that the main focus of competition policy is not upon industries per se but rather on markets. A market might be, for example, film development services. In such a market, suppliers might include photography stores, corner stores, drugstores, grocery stores, department stores, film development mailing houses, and so on. In competition analysis, it is important to think in terms of function (type of product or service) rather than institution (type of firm). In financial services, similar institutions, such as banks, do not compete in all product lines. Conversely, in any given product line or service, such as term deposits, competitors are not restricted to any one kind of institution, such as credit unions.

Canada's approach to competition policy and analysis is largely consistent with that of other industrial countries. This approach recognizes that the level of competition for a product or service is a function of a number of variables, including the number of firms offering competitive choices for that particular product or service (number of competitors) and the ease with which new competitors can enter the market (contestability). An extreme case which illustrates the importance of these variables is a market dominated by one firm. If there are no cost or regulatory barriers preventing new competitors from entering the market, the incumbent firm will be inclined to offer a competitive service to avoid the risk that a new entrant will take market share. In such a scenario, a market dominated by a single firm can still be competitive. On the other hand, a market with several firms but characterized by high barriers to entry may allow firms to behave in a way that results in their charging higher prices, or offering lower levels of service or quality.

Mergers between competitors are significant in competition law because they represent a potential decrease in the number of competitors in one or more markets. Therefore, competition law requires that merger transactions,[97] such as amalgamations, acquisitions and joint ventures, be looked at in terms of their potential for substantially lessening or preventing competition in any market. As the federal body charged with applying Canada's competition laws, the Competition Bureau is responsible for reviewing mergers affecting financial services markets, in addition to other markets.[98]

The main question the Competition Bureau examines in a merger is whether the transaction is likely to result in the substantial lessening or prevention of competition. The measure of the impact on competition is whether a transaction creates or enhances market power. Market power is "the ability to profitably maintain prices, quality, service and/or product variety for a significant period of time at levels that are less favourable to consumers than would exist in competitive markets."[99]

Simply put, would the competitors in a market be able to charge higher prices or reduce quality or variety following a merger? Or would there still be sufficient competition to ensure that suppliers attempting to raise prices or reduce quality or variety would lose market share as consumers turned to other suppliers?

Two of the key aspects to the Competition Bureau's merger analysis are: 1) the definition of a market, and 2) a market power test.

The market definition stage of the analysis involves identifying the specific markets for individual products and services in which the merger proponents participate. There are two components of market definition: determining the relevant product market and the geographic market. According to the Competition Bureau:

> Each relevant product market includes all products to which customers would likely turn in response to a small but significant, non-transitory increase in the prices of the offerings of the merging parties, and/or a reduction in quality, service or variety of the product offerings of the merging firms....

[97] The term "merger" as used in this paper does not strictly mean the amalgamation of two separate entities. The term is intended to include a variety of arrangements, including acquisitions and joint venture arrangements.

[98] The mandate of the Competition Bureau includes: "to obtain compliance with the [Competition] Act, and foster a climate of competition for the overall benefit of the Canadian economy and marketplace." *Annual Report of the Director of Investigation and Research, Competition Act* (Ottawa, March 31, 1997).

[99] Competition Bureau, *The Merger Enforcement Guidelines as Applied to a Bank Merger* (Ottawa, July 1998), p. 3.

> The geographic market includes all areas in which there are suppliers to which customers would likely turn in response to an attempt by the merging firms to exercise market power.[100]

As the Competition Bureau submission to the Task Force illustrates, the process of identifying individual markets is a difficult and inexact exercise.[101] This market definition stage "serves to identify the suppliers with which the merging parties compete and the geographic areas within which such competition takes place."[102]

The geography of a market is important to competition analysis because it determines how wide the net will be cast for the purpose of determining the number of competitors and hence the degree of competition, as well as for the purpose of assessing contestability. A firm may participate in thousands of small, regional markets across Canada and, at the same time, may be part of one large market across Canada or around the world. The geographic size of the market is dependent on a number of factors such as the nature of the product, the characteristics of the distribution channel and the purchasing patterns of customers.

The product definition can also be a challenge because of the need to consider the degree to which consumers view products as substitutes. While there may be very few suppliers for a narrowly defined product such as scheduled airline service to Florida, consumers faced with a large price increase might consider charter airline service or an alternative mode of transportation such as driving. The willingness of consumers to consider substitutes reduces the ability of suppliers to exercise market power.

After the market is defined, a market power test is applied to determine if the transaction in question would result in a substantial lessening or prevention of competition. For instance, if a merger would permit the newly found entity to effect a "significant price increase in a substantial part of the relevant market for a period of two years or more,"[103] this would demonstrate the exercise of market power. Other aspects of competition – such as variety, quality, service – are also taken into account.

The ability of competitors to sustain a price increase is very much affected by the existence of barriers to new entrants. A price increase leading to higher

[100] *The Merger Enforcement Guidelines as Applied to a Bank Merger*, pp. 4, 5. Under this "hypothetical monopolist test," "significant" usually means 5 percent and "non-transitory" means a price increase lasting at least one year (p. 12).

[101] *Submission of the Director of Investigation and Research, Competition Bureau, to the Task Force on the Future of the Canadian Financial Services Sector* (Ottawa, November 1997), pp. 23-32.

[102] Ibid., p. 25.

[103] Ibid., p. 12.

profitability would ordinarily attract new entrants to the market, and the price increase would be eroded as the new competitors become active. However, this would only be the case if there were low barriers to entry. Unlike the theoretical contestable market, where even a monopolist must offer competitive pricing because of the threat of entry by new suppliers, real-world markets have generally been found to have barriers to entry. For example, a new entrant would have to invest in a distribution network, while the incumbents' distribution network is a "sunk cost," having been paid for over many years. Another example is the potential switching costs incurred by consumers, which make them less willing to turn to a new entrant.

Competition analysis applies to financial services much as it does to any other sector. However, financial services pose a number of particular challenges to the analysis:

- ***Product complexity.*** Defining a "market" in the financial sector is complicated by the way in which financial services are packaged. Consider, for example, a deposit account, which might have several services attached to it: a savings feature which pays interest, chequing privileges, overdraft protection, ATM access, point-of-sale payment access, etc.
- ***Product range.*** The number of distinct product markets in which financial institutions participate can make for a very difficult analysis process. One financial institution listed 60 distinct businesses in which it competes.[104]
- ***Price.*** It is not immediately obvious how to measure the price of a loan. Is it the interest rate charged or is it the spread? How do service fees fit into the equation?
- ***Delivery channels.*** The variety of ways in which financial services are delivered also complicates the challenge of identifying markets. For example, is a low-rate credit card offered through the mail in the same market as a line of credit offered at the local bank branch?

For a large corporation anywhere in Canada, financial institutions in New York are part of the available market in wholesale financial services. For small and medium-sized businesses and some individual customers, this is generally not the case. For retail products, the geographic market tends to be smaller and more locally focussed, particularly in banking, reflecting the importance of the physical branch as a distribution channel. Also, small business customers and, to a lesser extent, individuals have shown a tendency to obtain many of their financial services from one financial institution. These purchasing patterns pose particular analytical challenges from a competition standpoint.

[104] Bank of Montreal, *Policy Alternatives for Canadian Financial Services*, submission to the Task Force (July 1997), p. 8. The products and services listed by the Bank of Montreal would probably not be the same as the "markets" that the Competition Bureau would identify for competition analysis purposes.

2. Local Focus of Retail Banking

Some aspects of retail banking remain branch-focussed. Functions such as cash deposit services depend largely on physical access to a branch. Research supports the view that branches have traditionally been important to small businesses and remain so.[105] For example, small businesses cite the importance of the relationship with branch managers in securing credit.[106] The Public Interest Advocacy Centre and the Consumers' Association of Canada found in their study that branch location was the factor individuals cited most frequently as the reason for choosing a particular bank.[107] Public opinion research conducted for the Task Force showed that two thirds of Canadians (67 percent) felt that it was extremely important to be able to do their banking in person at a branch.[108] Other research shows that the convenience of a particular branch ranks among the most important factors in selecting an institution, and that the rating has remained about the same for the last decade.[109]

Although many Canadians continue to value in-branch service, they also appear quick to adopt new distribution channels. Canadians are comfortable applying for credit cards through the mail, securing competitively priced mortgages over the phone with mortgage brokers, and conducting an increasing number of routine account transactions through ATMs, telephones and personal computers.

This is not to say that bank branches are no longer needed. Financial institutions support the view that the branch network will remain an important distribution channel for banking services, particularly as a base for the provision of advice. However, in the view of financial institutions, the concept of the branch is changing. As more routine banking transactions such as cash withdrawals and bill payments occur over alternative distribution channels, financial institutions are focussing on providing higher-value services such as investment products in their branches.

Not all banking services are available through alternative distribution channels. Not all consumers are comfortable with the alternatives to branch distribution. As a result, the market for some retail banking products remains branch-dependent and regionally focussed. This has implications for competition, particularly in the context of market consolidation. Not only might there be fewer

[105] A 1990 staff study by the U.S. Federal Reserve reviews several studies which suggest that proximity of a bank branch is an important factor in the selection of financial services. Gregory Elliehausen and John Wolken, *Banking Markets and the Use of Financial Services by Small and Medium-Sized Businesses* (Washington, D.C., September 1990), p. 5.

[106] Canadian Federation of Independent Business, *Submission to the Task Force on the Future of the Canadian Financial Services Sector* (October 1997), p. 8.

[107] PIAC and CAC, *Banking on Consumer Power*, p. 91.

[108] Ekos Research, *Public Opinion Research*, pp. 23-25.

[109] The rating ranged from 72 to 75 on a scale of 100 between 1988 and 1997. *The Goldfarb Report*, p. 59.

competitors in certain rural or remote locations, but the barriers to entry (e.g., the unit costs of setting up a physical branch) are higher. Accordingly, competition analysis must pay greater attention to the implications of market consolidation in such markets.

The application of technology will continue to expand the geographic scope of the markets which comprise retail banking in much the same way as it has for wholesale financial services.[110] However, this will take time and, to the extent that personal relationships remain important in the delivery of services, geography will remain a factor.

3. Clustering

"Clustering" occurs when consumers acquire products and services in bundles rather than individually. Clustering has implications for competition analysis. A firm which does not offer the full range of clustered goods or services may not be reasonably viewed as a competitive choice from the consumer's standpoint. If consumers demonstrate a tendency to purchase certain products and services in clusters, competition theory suggests that the bundle of products and services may need to be treated as one market for analysis purposes.[111]

There is some evidence of clustering behaviour in financial services markets. For example, at least two thirds of Canadians have obtained mortgages (68 percent), loans (74 percent) and credit cards (74 percent) from the same institution in which they do their primary banking.[112] The fact that an institution offers all the financial products and services that a person might need ranked among the top reasons given by Canadians for selecting a particular financial institution.[113]

However, there is also evidence of an unbundling of services in Canada. Sixty-one percent of Canadians report dealing with more than one institution for their various banking activities. Even in towns with populations under 1,000, a majority (53 percent) of Canadians report dealing with more than one deposit-taking institution.[114] Canadians have shown a particular interest in shopping around for investment products. Only 45 percent of Canadians indicated that

[110] The case for expansion of the geographic notion of "market" to reflect the impact of electronic delivery is forcefully argued in Brian W. Smith and Mark W. Ryan, "The Challenges Electronic Distribution of Financial Products and Services Will Present for the Assessment of Competition Among Providers of Those Services," paper presented to the Annual Conference on Bank Structure and Competition, Federal Reserve Bank of Chicago, May 1997. Evidence suggesting that it is premature to rely heavily on electronic distribution to mitigate local geographic concentration is presented in Myron L. Kwast, Martha Starr-McCluer and John D. Wolken, "Market Definition and the Analysis of Antitrust in Banking," *The Anti-Trust Bulletin* (winter 1997).

[111] The concept of "clustering" is described in greater detail in the Competition Bureau's submission. Competition Bureau, *Submission of the Director*, p. 26.

[112] Ekos Research, *Public Opinion Research*, p. 16.

[113] *The Goldfarb Report 1997*, p. 59.

[114] Ekos Research, *Public Opinion Research*, pp. 12-14.

they purchased all of their guaranteed income certificates (GICs) from their primary banking institution. Only 26 percent of Canadians purchased all their mutual funds there.[115]

The extent to which clustering behaviour should be considered a factor in competition analysis in banking is a hotly debated issue. Australia's Financial System Inquiry examined this issue in its review of that country's financial sector. It concluded:

> The cluster of services approach adopted in the Westpac/Challenge merger – where the majority of commonly used retail banking products were included in the cluster – should be closely questioned and at least narrowed.
>
> The products likely to be the focus of future bank merger assessments are transaction accounts and small business products, especially small business finance. This is because of the limited number of effective substitute suppliers to the banks for these products at this time.[116]

It should be noted that the profile of the Australian retail financial services customer described by the Financial System Inquiry in reaching its conclusions about clustering is not dissimilar to the Canadian context. For example, about 35 percent of Australians report dealing with only one institution for their banking-type products, as compared with 39 percent of Canadians.[117]

In retail banking, it is difficult to conclude whether clustering is driven more by supply- or demand-side factors. On the supply side, it may be that the historical importance of branch location as an access point for banking services has been a strong influence toward clustering of services. In this case, new distribution channels are likely to lessen the clustering behaviour among consumers.

However, if demand-side factors are strongly influencing clustering behaviour, changes may be less likey to occur. Consider credit products. As noted above, the research shows that many Canadians have credit products with their primary institution. An established financial record and relationship with a financial institution is often viewed as advantageous in securing credit. This may be particularly true in the case of small and medium-sized businesses.[118]

[115] Ekos Research, *Public Opinion Research*, pp. 16, 17.

[116] *Financial System Inquiry Final Report* (Melbourne, Australia, March 1997), p. 446.

[117] Ibid., p. 435. Ekos Research, *Public Opinion Research*, p. 12.

[118] The Canadian Federation of Independent Business stresses the importance of the relationship with branch managers for small businesses seeking financing under fair terms and conditions. The CFIB suggests that a higher incidence of turnover in account managers results in less understanding and knowledge of the small business and leads to more risk-averse behaviour by the bank. CFIB, *Submission to the Task Force*, p. 8.

Retail customers with established banking relationships might be less inclined to shop around beyond their primary financial institution for credit products.[119]

Since relationships are not as important for products such as GICs and mutual funds, there tends to be less clustering.

Overall, technology should further reduce clustering behaviour among consumers. On the supply side, the growth of electronic delivery channels and the entry of new players in traditional banking markets give consumers a wider choice of sources for financial services. On the demand side, the application of innovative technology (e.g., credit scoring) and the use of new delivery channels (e.g., the Internet) will reduce the need for bank customers to rely on established relationships.[120]

Financial services markets which demonstrate a local, branch-based focus, or for which consumers demonstrate a clustering behaviour in their purchase patterns, have implications for the definition of a "market" for the purposes of competition analysis. We shall return to this point in Chapter 7 in dealing with the merger review process.

Increasing Competition in Financial Services

The Task Force has concluded that Canadians will be best served by vigorous competition in the financial sector. The most effective role for government is to provide the environment in which competition in financial services is able to flourish. This can only be accomplished in the context of a clear vision of the evolution of the financial services sector.

The Canadian financial services sector has historically emphasized safety and soundness at the possible expense of competition. The Task Force believes that changes can be made that encourage greater competition while safeguarding key public policy objectives. The Task Force proposes a four-part strategy to enhance competition in the Canadian financial services sector. The four components are:

- supporting greater competition among existing players;
- removing barriers to entry for new players;

[119] Based on a 1998 survey, the Canadian Bankers Association reported that 86 percent of small and medium-sized businesses approached only one financial institution for their financing. Thompson Lightstone & Company, *Small- and Medium-Sized Businesses in Canada: An Ongoing Perspective of Their Needs, Expectations and Satisfaction with Financial Institutions,* Vol. One, (Toronto: CBA, 1998), p. 54.

[120] Although only a first step, Wells Fargo's entry into the Canadian market using mail and electronic channels for small business lending is an example of inroads being made in this regard.

- removing barriers to entry faced by foreign competitors; and
- strengthening the bargaining power of consumers through better disclosure and redress mechanisms.

This section provides an overview of each component of the strategy. Specific proposals are described in more detail in later chapters of this paper or other background papers.

Competition among Existing Players

The greatest potential for increased competition in financial services lies among the existing competitors within the financial sector.

For the better part of the past century, financial services legislation attempted to confine the activities of institutions within narrow "pillars." However, the quest to provide customers with a broader range of products and services gradually prompted firms to look beyond their traditional pastures for greener fields. Despite legislative barriers, financial institutions were driven to find ways to enter new markets: insurance companies began offering insurance-based savings products, trust companies became banking institutions and banks found it appropriate to underwrite debt securities for their corporate clients.

Market forces, fuelled by the removal of many of the legislative barriers that previously separated the pillars, have been driving change in financial services at an unrelenting pace over the last two decades. In the 1980s, banks entered the securities business. Since 1990, mutual fund companies have grown and established themselves as effective competitors in the market for savings products. Through innovative applications of technology, unregulated finance companies have become important in wholesale finance markets.

Removing unnecessary restrictions on the activities of firms in the financial sector and providing them with greater organizational flexibility will make more competition possible in the financial services market. The Task Force proposes changes in five specific areas:

- more powers for institutions to network or directly offer financial services to their customers;
- a more flexible ownership regime for financial institutions to facilitate alliances among institutions;
- demutualization rules that will permit mutual insurance companies to become stronger competitors;

- greater flexibility for credit unions to allow them to become more vibrant competitors; and
- fair and open access to financial networks used by groups of institutions – such as financial payments and transaction systems – so as not to inhibit competition.

1. Powers

Governments are to be commended for their efforts over the last two decades to remove the barriers which artificially separated the pillars. However, the process of opening the market to full competition is not complete. For example, as part of its scheduled five-year review of the financial services sector, the federal government made the decision in 1996 not to remove the remaining restrictions on the powers of federally incorporated financial institutions. The Minister of Finance announced in the March 1996 budget speech, "[w]e have concluded that the financial sector has yet to fully adjust to [the 1992 legislative] framework. Therefore, the present restriction on banks selling insurance will be maintained."[121]

In 1992, federally incorporated financial institutions were given the authority to offer the financial products of other financial institutions, including those of their own subsidiary institutions, through their distribution channels. This enabled federal financial institutions to offer a broader range of services to an existing customer base. However, restrictions were maintained in two key areas: insurance distribution and automobile leasing. Deposit-taking institutions were, with some exceptions, denied the ability to offer insurance products through their branch networks. All federally incorporated financial institutions were denied the ability to offer lease financing for automobiles. The Task Force proposes that these restrictions be removed, after a reasonable transition period, and subject to certain changes to consumer protection laws to prevent abusive behaviour. Removing these restrictions will give consumers greater choice in their selection of insurance and automobile-leasing products. Greater competition could also lead to more innovation in product design and distribution, and to lower prices.

A second area in which more powers could lead to greater competition is in payments services. Although insurance companies are able to own deposit-taking institutions and offer payments services to their own customers, this has proven to be a costly way to enter the business. Life insurance and mutual fund companies already hold funds on behalf of their clients; these are, in essence,

[121] Budget Speech, Hon. Paul Martin, P.C., M.P., Minister of Finance, March 6, 1996.

deposit-like substitutes which could serve as the basis for payments services. The Task Force proposes that the Department of Finance give high priority to a prompt review of the question of access to payments so that life insurers, money market funds and investment dealers can participate in the payments system as soon as possible.

With an increase in the range of providers that can offer payments services, it is expected that consumers will have greater choice and access to potentially more innovative payments services.

Competition among existing players will also be enhanced by ensuring that there is competitive equity between competitors offering equivalent products and services. This means ensuring that providers of equivalent products and services face the same type of regulations. It also means, for example, that compensation plans should not create a competitive imbalance between similar types of products and services.

The proposals regarding powers is discussed in greater detail in Background Paper #2, *Organizational Flexibility for Financial Institutions: A Framework to Enhance Competition*. Compensation plans are discussed in Background Paper #5, *Improving the Regulatory Framework*.

2. Facilitating Alliances

The Task Force proposes a number of changes to the current ownership regime, intended to provide institutions with greater flexibility to enter into alliances that could increase innovation and competition.

The proposed new ownership regime will give smaller financial institutions greater flexibility to be closely held, subject to prudential safeguards. The largest financial institutions will have to be widely held but would be able, with Ministerial approval, to have shareholders that own up to 20 percent of the shares. This possibility will provide these institutions with greater flexibility to enter into alliances.

The Task Force is also proposing a holding company option that would allow financial institutions to more flexibly arrange their business activities in a way that could further facilitate business alliances.

In addition, the proposed changes to accounting rules will remove a hurdle that places Canadian institutions at a competitive disadvantage to international rivals in entering into alliances and other business combinations.

The overall impact of these proposals should be to allow the emergence of a more vibrant range of competitors in financial services. This should result in greater competition and, for consumers, more choice, increased innovation and lower prices.

The ownership and holding company proposals are discussed in greater detail in Background Paper #2. The changes to accounting rules are discussed in Chapter 5 of this paper.

3. Demutualization

One challenge faced by mutual insurance companies – companies owned by their policy holders – is the inability to access equity markets. This constrains mutual companies from using equity to make acquisitions, enter into venture arrangements or set up management performance incentive programs through stock options. Such flexibility is important in an era of change and consolidation in financial services.

The Canadian government gave approval in principle for demutualization in 1992. Since then, four major Canadian life insurers have announced their intention to demutualize and become publicly traded stock companies. The Government has recently made public the process by which the demutualization of these companies can occur.

The Task Force is proposing an ownership regime that would give mutual insurance companies a three year transition period after their demutualization. This would give demutualized insurance companies the protection they need to develop into strong competitors to banks, while providing them with flexibility to enter into innovative and creative ventures provided they are demonstrated to be in the public interest. From their base in insurance, retirement planning and asset management, and with the flexibility provided by access to equity capital and the possibilities of new alliances, these firms will have an opportunity to extend the reach of their services and assume a higher profile in the Canadian and international financial landscape. This will benefit consumers by providing more competition, increased choice and greater innovation.

This proposal is discussed in greater detail in Background Paper #2.

4. Flexibility for Credit Unions

Cooperative financial institutions play an important role in meeting the needs of Canadians, and this importance could increase as the financial sector restructures. The cooperative sector warrants special attention because there is

an opportunity for the credit union movement to become a greater competitive force in Canada. The challenge lies with credit union leaders and members to develop a regime that accomplishes this objective. However, government can provide a legislative framework that enables cooperatively owned institutions to become a more vigorous source of competition in financial services.

To unleash the competitive power of the cooperative movement, the Task Force proposes a cooperative bank ownership structure under federal legislation which would enable provincial credit unions and caisses populaires and their Centrals, subject to provincial approval, to operate nationally focussed institutions under the traditional member-owned structure. The Task Force also proposes that the credit union movement and government work together to achieve a more flexible framework of business powers for the centrals that would enhance the vibrancy of the credit union movement.

This proposal is discussed in greater detail in Background Paper #2.

5. Networks

Access to electronic networks is becoming increasingly crucial to the operation of financial institutions. The traditional paper-based cheque-clearing system has been augmented by credit card settlements, point-of-sale systems, ATMs, global securities custody networks, and joint venture back-office trading and processing systems. To preserve and enhance competition as financial networks multiply, these systems must offer open access on reasonable terms to existing and new competitors.

Barriers to Entry for New Players

New entrants, and even the threat of new entrants, force incumbent firms to be vigorous competitors. For prudential reasons, the current regulatory system features many impediments that deter new start-ups. This was observed in the Global Competitiveness study noted earlier in which Canada ranked 39th out of 53 countries in terms of the ease of entry into banking. Many of these impediments may not be necessary from a public policy standpoint.

In particular, Canada has not witnessed the same level of entrepreneurial activity in the start-up of new financial institutions as elsewhere. In the United States, as consolidation among large institutions gains momentum, local start-ups of small banks continue, fostered by flexible start-up requirements. For example, 207 commercial banks were started in the United States in 1997.[122]

[122] Number of new insured commercial banks. Testimony of Governor Laurence H. Meyer before the Committee on Banking and Financial Services, U.S. House of Representatives, Federal Reserve Board, April 29, 1998.

Four areas in which specific legislative and policy changes will encourage new entrants and greater competition are: less burdensome start-up requirements, a more flexible ownership structure, a renewed OSFI mandate and a lower tax burden.

1. Less Burdensome Start-Up Requirements

The manner in which regulatory discretion is used in the start-up of a financial institution sends a strong message about the types of institution that are deserving of this privileged status. The Task Force believes the message sent by government should be welcoming to new, innovative firms, subject only to reasonable limitations on prudential grounds. This open-door policy should coincide with a more streamlined approach to processing new applications.

Certain specific legislative changes might immediately signal the more open-door policy. For example, to facilitate the incorporation of special-purpose banks or other financial institutions (special purpose by either geography or product line), the Minister of Finance should have discretion to allow new financial institutions to incorporate with less than the $10 million in capital currently required under federal legislation. This would be subject to consideration of the institution's proposed functions and business plan. Moreover, the time required to approve a new incorporation should not normally exceed 120 days.

These measures, together with the proposed ownership policy, should encourage the creation of new competitors and create opportunities for the development of new and innovative institutions.

2. Size-Based Ownership Framework

Under the Task Force's proposed ownership regime for federal financial institutions, it would be easier and more rewarding for an individual or group to start a financial institution. Entrepreneurs would have a choice of ownership structure, including direct ownership, the use of a holding company or a cooperative ownership regime. The rules are structured to require wide public ownership only after the institution has achieved a large size, and widely-held status only for the largest firms.

It is expected that the more flexible ownership model will encourage entrepreneurial interest in the creation of smaller, more innovative financial institutions for the benefit of Canadians, without unduly adding risk to the financial system as a whole.

This proposal is discussed in greater detail in Background Paper #2.

3. Role of OSFI in Competition

Not only must the start-up rules support a more entrepreneurial and innovative approach to financial services regulation, but the regulators must also adopt this approach as part of their supervisory culture. For this reason, the Task Force proposes a change in the mandate of the Office of the Superintendent of Financial Institutions, the prudential regulator of federal financial institutions. This renewed mandate would make it clear that OSFI is to balance its supervisory objective with the goal of facilitating competition.

This proposal is examined more fully in Background Paper #5.

4. Lowering the Tax Burden

Capital taxes may be a significant barrier to entry for smaller institutions. The federal large corporations tax of 0.225 percent of capital is applicable to companies with capital of more than $10 million, capturing almost all financial institutions. In addition, federal Part VI capital tax applies to institutions with more than $200 million in capital. This means that any bank or trust company with more than about $4 billion in assets is subject to a tax which is payable even if profits are not earned. Since Part VI tax is creditable against income tax payable, it functions as a minimum tax and is a less significant burden for large, profitable institutions.

Over 60 percent of the $872 million in capital taxes paid by financial institutions in 1996 was collected by the provinces. Application of capital taxes varies among the provinces but has generally increased in recent years through higher rates and broader definition of the capital base. A small deposit-taking institution with only $10 million in capital, doing business in all provinces, could expect to pay $219,500 in annual capital taxes, or 2.2 percent of its capital, even if it is not profitable.[123]

The impact of capital taxes on a new enterprise is quite significant. Since a new institution is vulnerable to greater risk, it makes little sense to further undermine its strength by eroding its capital base. Moreover, most institutions experience losses in the periods immediately following their start-up and thus have no income against which to credit capital tax. The capital tax represents a hit, beyond any losses, on capital. In the end, capital taxes serve as a significant financial barrier to entry for potential competitors.

[123] This estimate is for illustrative purposes only and does not reflect the complexities in actual corporate tax returns. It is based on 1996 capital tax rates for an institution doing 10 percent of its business in Atlantic Canada, 15 percent in BC, 20 percent in the Prairies, 25 percent in Quebec and 30 percent in Ontario. Federal large corporations tax would be $22,500, and the sum of provincial taxes payable would be $197,000. Provincial capital tax rates range from 1 to 3 percent of capital, with formulas being mandated by the provinces to deem the percentage of total capital to be taxed in each province.

The Task Force proposes a 10-year holiday for new financial institutions from federal capital taxes (both large corporations and Part VI capital tax) and urges provincial governments to consider similar proposals. Provinces will want to consider such holidays in order to encourage new entrants in their own jurisdictions.

Tax holidays of this nature from the general large corporations tax would be particularly advantageous for small institutions. The exemption would give these institutions the ability to establish themselves and grow without seeing their capital unduly eroded because they were initially unprofitable.

Revenue loss to the federal government (and provincial governments, if they followed suit) would be small, as total capital taxes paid by new financial institutions would be only a small portion of the total paid by the industry.

Barriers to Entry for Foreign Financial Institutions

Foreign financial institutions operating in Canada are, and will continue to be, an important source of effective competition in Canada. In fact, foreign financial institutions are already prominent in some segments of the Canadian financial services markets, such as property and casualty insurance.

Rules are necessary to ensure that the interests of Canadian consumers are protected if we are to allow foreign financial institutions to operate in Canada. However, these rules should not act as unnecessary barriers to entry for greater foreign competition. In the past, entry rules have, in varying degrees, served as barriers to foreign competition. This has been most evident in the traditional deposit-taking industry, in which the number of foreign bank subsidiaries is more than triple that of domestic banks but the former account for less than 10 percent of banking assets in Canada.[124] This history of barriers to foreign bank entry is evident in the World Competitiveness Survey (mentioned earlier in this chapter), which ranked Canada 41st out of 53 countries in terms of the degree of competition from foreign banks.[125] Although the federal government has gradually relaxed many of these restrictions, there is opportunity for further reduction of barriers.

[124] Exhibit 8.1 demonstrates that no more than 15 percent of banking sector assets at any time over the last 10 years belonged to foreign-controlled banks.

[125] World Economic Forum, *The Global Competitiveness Report* (Geneva, 1997).

1. Current Restrictions

There are two ways in which a foreign bank can do business in another country. The first is by setting up or acquiring a bank as a wholly or partially owned subsidiary of the foreign bank. A second method is for the foreign bank to enter directly as a branch operation of the parent company.[126]

During the mid-1960s, the threat of a takeover of a Canadian bank by foreign banks prompted the federal government to impose a restriction on bank entry into Canada. In 1967, a 10 percent limit on the ownership of bank shares was applied to achieve this purpose. This meant that foreign banks were not permitted to own bank subsidiaries in Canada. At the same time, foreign banks were also prohibited from entering on a branching basis. Despite these restrictions, foreign banks continued to enter Canada through subsidiaries that were legally not considered banks but performed many banking activities. The result was that by 1980, foreign banks held almost $10 billion in assets in Canada (in contrast to the $150 billion held by Canadian banks).[127]

Amendments to banking laws in 1980 permitted foreign banks to enter by setting up in Canada either through a foreign bank subsidiary or through non-bank subsidiaries, all of which required federal government approval. Through a foreign bank subsidiary, foreign banks were permitted to engage in a broad range of banking activities, but were subject to a ceiling on total assets in Canada as a group. Non-bank subsidiaries of foreign banks faced restrictions on their activities, but were not subject to rigid supervision.[128] The asset ceiling was removed for U.S. bank subsidiaries pursuant to the Canada-U.S. Free Trade Agreement (FTA) in 1989, for Mexican bank subsidiaries under North American Free Trade Agreement (NAFTA) in 1993, and for all banks in 1994 pursuant to the Uruguay Round Trade Negotiations. Foreign bank entry through branch operations was not permitted under the 1980 changes.

As a result of the 1980 amendments, the number of foreign banking licences issued by the federal government rose to 57 by 1982.[129] The number of foreign bank subsidiaries reached a high of 59 in 1987, and has since declined to about 44 at the beginning of 1998.[130]

126 The reference to a "branch operation" should not be confused with the term "bank branch." Branch operation refers to the ability of a foreign bank to enter a jurisdiction without setting up a separate legal entity, such as a subsidiary.

127 Robert MacIntosh, *Different Drummers: Banking and Politics in Canada* (Toronto: Macmillan, 1991), p. 177.

128 These non-bank subsidiaries were generally finance companies funded through means other than Canadian deposits.

129 MacIntosh, *Different Drummers*, p. 178.

130 Information from the Canadian Bankers Association and OSFI.

In 1987 and 1992, amendments to federal financial institutions legislation permitted Canadian banks to own other types of financial institutions, namely securities dealers, insurance companies and trust companies. This authority extended to the Canadian bank subsidiaries of foreign banks. Amendments to banking legislation in 1997 permitted foreign banks to hold certain financial institutions directly (rather than through the foreign bank subsidiary). These included federally incorporated trust, loan and insurance companies as well as securities dealers.

In its 1996 White Paper, the federal government undertook to relax the restrictions on foreign bank entry. In 1997, the federal government also committed to permitting foreign banks to enter via branch operation. In September 1997, the Department of Finance published a consultation paper outlining options for easing restrictions on foreign bank entry.

2. Branching

The consultation paper outlined the conditions under which a foreign bank would be permitted to branch into Canada. The foreign bank must:

- have $25 billion in assets worldwide;
- be widely held;
- have international banking experience;
- have the consent of the regulator in its home jurisdiction;
- demonstrate “favourable performance” in the last five years; and
- be regulated and supervised in a suitable manner by the bank’s home jurisdiction.

The branch operation would not be permitted to accept retail deposits (generally defined as deposits under $150,000). It would be subject to a “capital equivalency” requirement: the branch operation would be required to hold a specified deposit of high-quality securities free of encumbrances with an approved Canadian financial institution.

3. Relaxed Entry Rules

In addition to the branching regime, the 1997 consultation paper contained proposals to provide a greater range of options for foreign banks wishing to operate in Canada. The consultation paper presented two regulatory models for foreign banks[131] operating in Canada that would broaden the range of options:

[131] Legislation in 1997 eased the restrictions faced by “near banks” – institutions which do not accept deposits and which are not regulated as banks in their home jurisdiction but which are caught by the broad definition of a “foreign bank” contained in legislation.

Option I. Foreign banks would be able to choose either a regulated or unregulated stream. Under the regulated stream, a foreign bank could have one or more of the following: a branch operation, a foreign bank subsidiary, a regulated trust, loan and insurance company, and a securities dealer. Alternatively, the foreign bank would be permitted to operate an unregulated subsidiary in Canada if its activities did not include deposit-taking, insurance or fiduciary services.

Option II. All activities of foreign banks in Canada would be regulated, whether performed through a subsidiary or on a branching basis. The subsidiaries, like Option I, would include a foreign bank subsidiary, a regulated trust, loan and insurance company, and a securities dealer. However, a foreign bank would also be able to set up a limited-purpose, lightly regulated financial institution to conduct activities which do not give rise to regulatory concerns, such as credit card or leasing services.

4. Observations

In accordance with the broader objectives of increasing competition in the Canadian financial services sector, the Task Force supports initiatives that would remove barriers to entry faced by foreign banks. These include giving foreign banks the ability to enter through branch operations and allowing foreign banks to conduct activities which generally do not require prudential regulation on a light or unregulated basis.

The Task Force thus supports the Department of Finance proposal to allow foreign banks to enter Canada through branch operations. The Task Force acknowledges that regulation is required of the branch operations of a foreign bank in much the same way that a foreign bank subsidiary would be subject to regulation. However, the rules intended to regulate branch operations should not serve as an unnecessary barrier to entry for foreign financial institutions. Specifically, the Task Force is concerned that the proposed $25 billion worldwide asset requirement is too stringent and may deter potential competitors from entering the Canadian market.

Where the subsidiary of a foreign bank does not engage in activities which give rise to prudential concerns, the Task Force believes that the lightest, or indeed no, regulation should apply. Working with institutions is the best way to arrive at an appropriate regime. The Task Force is not troubled by any potential competitive anomalies between foreign and domestic banks created by such a regime. The Task Force believes that the objectives of greater competition are a higher priority. Moreover, the holding company model proposed in Background Paper #2 will address some of these concerns by giving domestic institutions greater structural flexibility to arrange their business affairs.

The Task Force recognizes that allowing foreign banks to accept retail deposits on a branching basis poses serious policy and regulatory challenges. A branch operation is not a separate entity with its own level of management. Government does not have at its disposal the same regulatory levers to ensure that the branch operation is operated in a manner that is expected of domestically incorporated institutions. The government would largely have to defer to the regulation of the financial institution's home jurisdiction. Moreover, access to the assets of the financial institution operating on a branching basis is not assured in the event that the institution fails. These challenges could be overcome by placing contractual and regulatory requirements on the foreign institution upon entry, but those requirements would be largely equivalent to setting up a subsidiary.

Canada is not out of step in imposing stronger prudential requirements on foreign banks wishing to accept domestic retail deposits. Since few foreign banks have shown interest in entering the retail deposit-taking business,[132] it is not unreasonable to require that retail deposits be taken in Canada only through a Canadian regulated deposit-taking institution.

Strengthening Consumers' Bargaining Power

Vendors of financial services still enjoy a considerable information advantage over retail customers. Many consumers are bewildered by the choices available in financial services and their underlying financial implications. And if products or services fail to meet customers' expectations, they tend to feel limited in their options for addressing their concerns.[133]

This may be changing. As consumers, Canadians are becoming more demanding. They are inclined to shop around for a better loan or mortgage rate.[134] They show greater prudence in their selection of investment vehicles. They are showing a strong interest in more information on the products and services that are available.[135] This trend is important in levelling the information imbalance that currently exists between financial institutions and their retail customers. A more knowledgeable and demanding consumer, with easily accessible redress options, is a stronger competitive force.

132 The ability of foreign banks to accept retail deposits on a branching basis historically has not been a priority issue for banks seeking to improve foreign bank access to Canadian financial services markets. Hongkong Bank of Canada and ING Bank are two examples of institutions which accept retail deposits and demonstrate that it is possible to make inroads into the Canadian retail deposit-taking market, even under the current foreign bank subsidiary regime.

133 For example, 62 percent of Canadians are unaware of the existence of bank ombudsmen. Ekos Research, *Public Opinion Research*, p. 32.

134 In 1997, 57 percent of Canadians indicated that they would shop around for a better mortgage rate when renewing. This is up from a low of 41 percent in 1989. *The Goldfarb Report 1997*, p. 89.

135 Sixty-four percent of Canadians feel they are not being adequately informed about the products and services they are buying. Ekos Research, *Public Opinion Research*, p. 53.

Background Paper #3 looks at methods of empowering consumers through strengthening required disclosure, providing a comprehensive ombudsman system to facilitate redress and dealing specifically with coercive tied selling.

Chapter 5

International Competitiveness

Given the forces of globalization affecting Canadian financial markets and financial service providers, the international competitiveness of Canadian financial institutions is an important issue. An internationally competitive financial services sector will be capable of providing world-class service levels to Canadians at home as well as in world markets. And the Canadian economy benefits from a strong export industry in financial services. If Canadians are to enjoy these important benefits, our policy regime must facilitate international competitiveness.

This chapter's discussion of international competitiveness, its benefits and the supporting policy proposals can be summarized in six points:

- The basis for an internationally competitive Canadian financial services sector is a domestic market characterized by efficient and competitive financial service providers.
- Canadians are best served by world-class service levels for financial products and services, which can be provided by internationally competitive businesses.
- Canadians care about who their financial service providers are. As discussed later in Chapter 8, there may be distinct advantages to Canada in having a financial services sector which is primarily Canadian-controlled.
- The Task Force concludes that, by and large, most of the major participants in the Canadian financial services sector are or have the potential to be internationally competitive. There is no need for special measures to protect the sector from foreign competition.
- As competition intensifies from both foreign and domestic participants, existing institutions will have to rethink their strategies and adjust to become world-class.
- The policy framework that will best serve Canadians is one that does not unduly restrict competition or unnecessarily hinder Canadian institutions' attempts to become world-class.

International Competitiveness and Domestic Markets

Benefits

Why should one care about the international competitiveness of the financial services sector? What benefit does international competitiveness bring to the average Canadian and to non-financial Canadian enterprises?

International competitiveness is a means of benchmarking Canadian prices and service levels for financial products to world-class standards. It is an objective and efficient way to ensure that Canadians are getting financial products and services at prices and service levels which are the best the world has to offer. This is important for every business, as well as individuals, because all of them use financial services in their daily activities. The efficient delivery of those services enhances the competitiveness of the rest of the Canadian economy.

There are a number of other important benefits to be gained from the export of financial services:

- the availability of high-quality employment which will assist in diminishing the drain of Canadian employment talent abroad;
- greater tax revenues from profitable enterprises; and
- growth and development in Canada stemming from the clustering of service providers and new entrants around successful world-class firms.

Relationship with Domestic Competition

The ability to compete internationally is fostered by a dynamic home market with a number of vigorous competitors and a variety of efficiently produced services. This is especially true for a sector as large and as central to the economy as the financial services sector.

Domestic competition is associated with international competitiveness in a number of ways:

- Strong domestic competition forces the adoption of low-cost production methods and service structures, a necessity for foreign market penetration.
- Technical and management skills are honed in the domestic market. Human capital is developed in domestic financial centres, and provides a key resource to financial firms offering services abroad. Low-cost and efficient management structures are perfected in a competitive environment.
- Another key input for financial services firms is technology and innovation. Competitive pressures force the adoption of new technology and the creation of innovative products – elements which are advantages in foreign markets.
- A good track record in a vigorous and sophisticated domestic market provides recognition and credibility in seeking foreign business.

Canadian Control

The Task Force has concluded that Canadian control of the financial services sector is desirable for a number of reasons. As discussed in Chapter 8, Canadian control is seen as desirable because of the benefits and associated economic advantages of having a domestic financial centre, taxation revenue, sensitivity to domestic market conditions, and diminished impact of extra-territorial application of foreign laws. A Canadian-controlled financial services sector that is internationally competitive may contribute to the achievement of these goals, and a diversified mix of international business will enable Canadian financial firms to weather the difficulties that may arise in domestic financial markets from time to time.

In adopting a public policy of Canadian control, it is important to have Canadian firms that are internationally competitive. They must be able to defend their positions in the Canadian market vis-à-vis foreign competitors, as well as compete effectively in international markets. From this perspective, there is really no trade-off between international competitiveness and Canadian control. International competitiveness of Canadian firms is a sound and efficient means of promoting Canadian control without the costs to consumers that protection would entail.

International Competitiveness of Canada's Financial Sector

The Canadian financial sector measures up reasonably well against its international competitors in several markets. Banks, life insurers and asset managers are well placed to defend most of their home markets. In other market segments (e.g., global corporate and investment banking), Canadian institutions as they stand today may be limited to cultivating niches where they have developed or acquired expertise and market share. On the domestic side, the Task Force proposals to enhance domestic competition through facilitating new Canadian and foreign entrants will increase pressure on existing institutions to rethink their strategies and adjust to meet the new competition. Regulatory policy should not stifle such adjustment, so long as prudential and public interest concerns are met.

Global Competitiveness Survey

In its 1997 report, the World Economic Forum ranked Canada's financial system fifth in competitiveness, among a sample of 53 more-developed countries.[136] The report is discussed in greater depth in Chapter 4 of this paper.

[136] World Economic Forum, *The Global Competitiveness Report* (Geneva, 1997). The Swiss-based International Institute for Management Development also produces an international competitiveness report. See *The World Competitiveness Yearbook* (Lausanne, May 1998), which ranked Canada 12th in the world in terms of the competitiveness of its financial system (in the previous two years, Canada ranked 10th and 13th) in a sample of 46 of the more-developed economies. The World Economic Forum's report provides more useful detail on the financial sector.

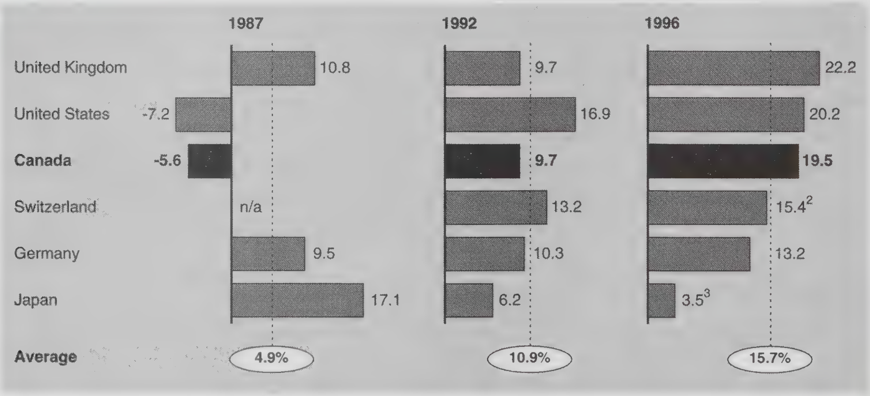
The report suggests that Canada ranks quite highly in the development of its capital markets. However, Canada is perceived to be protectionist in its approach to banking, in that new entry into its banking industry is difficult and the degree of foreign competition is low. While a considerable part of the survey is based on the judgment of the executives interviewed, it can claim to be representative of the opinions of this group, with implications for the nature of decisions taken on the location of financial business initiatives and choices about the use of financial services across countries.

Profitability

A more concrete perspective on the competitiveness of Canadian institutions can be provided by data on their profitability. While not in the high ranges achieved by the more profitable global investment banks and leading large domestic banks in the United States and United Kingdom, the profitability of Canadian financial firms has improved in recent years. Canadian bank profitability compares reasonably well with that of foreign banks in major countries, as indicated in Exhibit 5.1. Banks have been able to progressively increase their profitability, despite falling interest rate margins by generating increases in their non-interest income – fees and trading gains. Declining loan losses have also contributed to profitability.

Exhibit 5.1
Profitability of Banks
Net Income/Total Revenue[1]

Percentage



[1] Average of Top 5 banks per country, except U.K. 1987 average of Top 4.

[2] Based on net income before 1996 special provision for bad loans, average of Top 4.

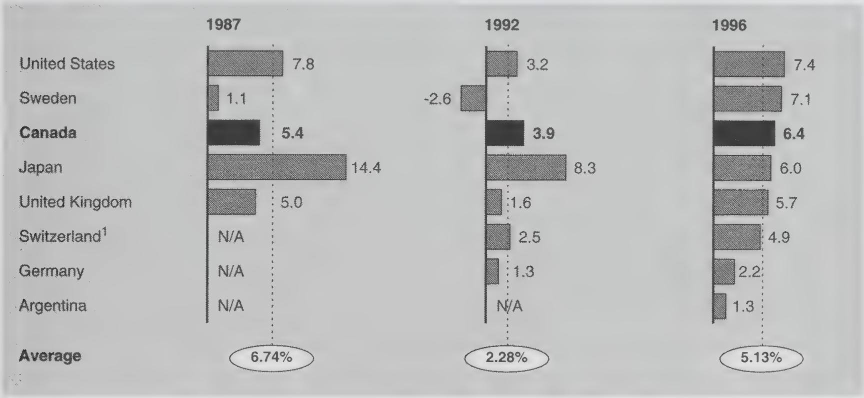
[3] Excluding Dai-Ichi.

Source: McKinsey & Company Global FIG Practice.

Canadian life insurers have also improved their profitability in recent years to a point where they slightly lag top firms in the United States and Sweden. Improved performance is attributable to growth in new lines of businesses and stronger assets (see Exhibit 5.2).

Exhibit 5.2
Profitability of Life Insurers
Net Income / Gross Premiums
Top 5 Organizations

Percentage



[1] Average of Top 4 organizations.

Source: McKinsey & Company Global FIG Practice.

Efficiency Measures

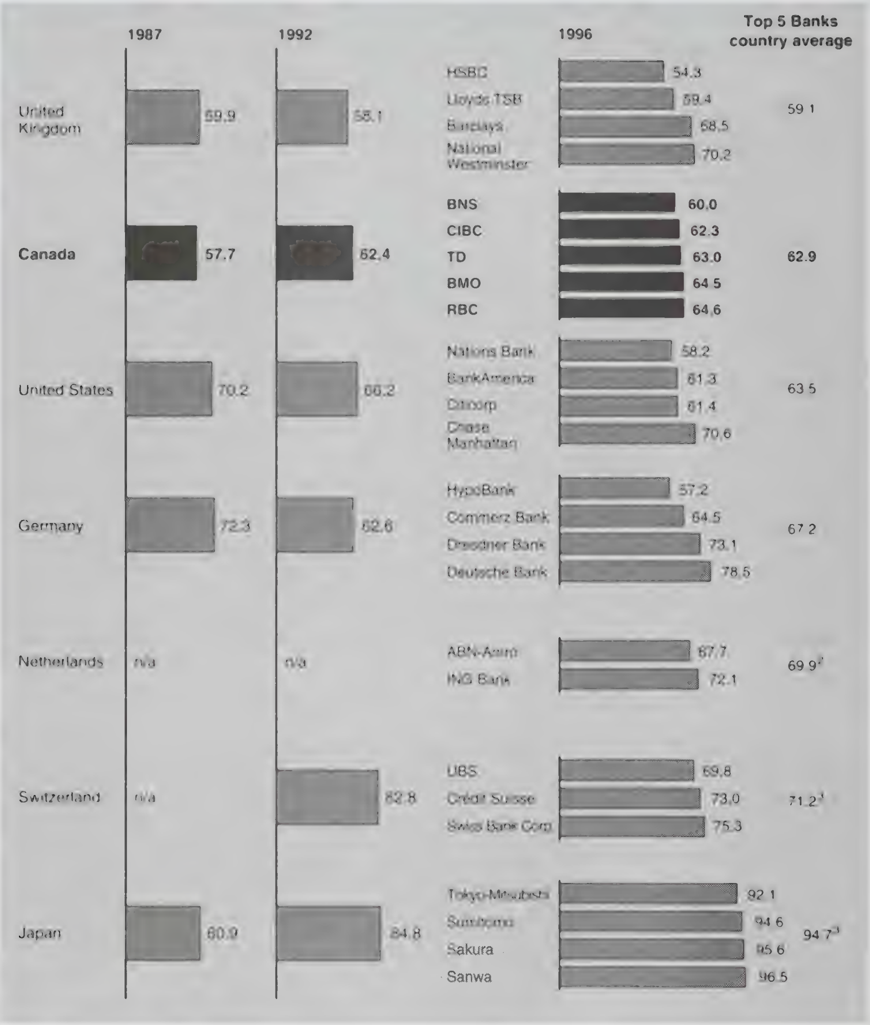
A traditional measure of efficiency used in the analysis of banking is the ratio of non-interest expense to total income. Based on international comparisons, this measure also shows Canada measuring up reasonably well, with the major Canadian banks as a national group ranking second among those of the seven major countries shown in Exhibit 5.3.[137] However, efficiency of Canadian banks has deteriorated over time.

In other countries there is considerable variation in the efficiency measures among institutions. Because the efficiency measure is sensitive to the mix of business carried on by each institution, company comparisons are best undertaken within a group of peers. The impact of differences in mixes of business between institutions is minimized when a countrywide average – across a number of firms – is used.

[137] Because the profitability and efficiency measures show the "top five" banks for each country, the measures are not necessarily comparable, especially between countries with different degrees of concentration in their banking systems.

Exhibit 5.3

International Comparison of Bank Efficiency Ratios[1]



[1] Non-interest expense divided by total income.

[2] Average of Top 2.

[3] Average of Top 4.

Sources: Bankscope; Datastream; IBCA; Worldscope; Global Vantage; annual reports; McKinsey & Company Global FIG Practice.

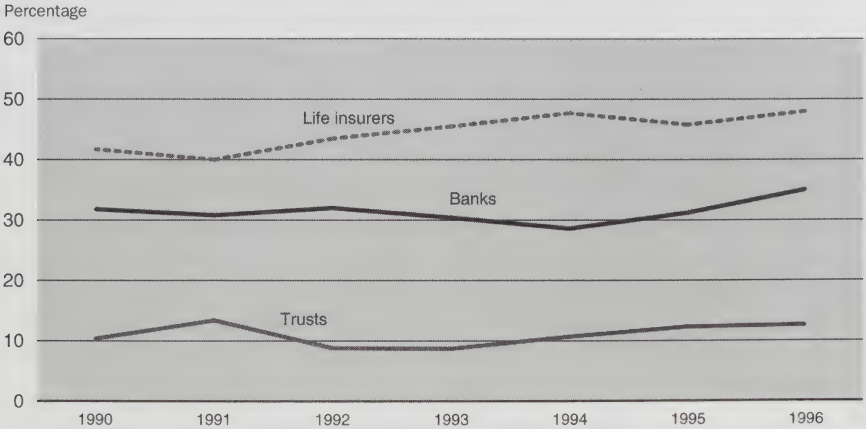
The Canadian banks' efficiency measures are within a narrow range of each other. This suggests that while they have achieved an acceptable level of efficiency, they have each developed a similar mix of businesses and none of them has been able to pull away from the pack in adopting new and effectively different means of delivering services. In addition, they have not been able to achieve the significant recent gains in efficiency demonstrated by some major U.S. banks, a phenomenon likely to continue with the consolidation occurring in American banking.

Recently, some larger banks have made major gains in efficiency. Chase Manhattan, for example, made an eight-point gain over the two years ended 1997, and Lloyds TSB Group reported a seven-point gain in 1997.[138] In contrast, the Canadian banks have shown some deterioration in efficiency over the 10-year period shown in Exhibit 5.3, and since 1996 on balance they have shown little change.

International Orientation

The international orientation of Canadian banks and life insurance companies is shown in Exhibit 5.4.

Exhibit 5.4
Foreign Orientation of Canadian Financial Institutions



Banks and trusts: data represent foreign currency share of total assets.
Life insurers: data represent share of premiums written outside Canada.

Source: The Conference Board of Canada.

[138] The Chase Manhattan Corporation, 1997 Annual Report, and Lloyds TSB Group, 1997 Full Year Results. Note that the efficiency numbers reported by Chase Manhattan differ from the data reported by McKinsey & Company in Exhibit 5.3, because the McKinsey analysis includes restucturing charges, while these are excluded by Chase Manhattan in its annual report.

Both banks and life insurers have considerable foreign operations relative to their Canadian business, and the foreign shares have been trending upward in recent years. Life insurers generate almost half of their premium flow outside Canada. A significant but much lower relative share of the business of Canadian trust companies is foreign. Canadian property and casualty insurers (not shown) have little foreign business.

When financial services firms operate internationally, they are faced with a complex set of regulatory requirements as well as the business environment in the host country. In most cases, they must set up or acquire subsidiaries in the foreign market to distribute financial products. This militates against the foreign orientation of financial services firms relative to goods-producing firms, which arguably have fewer obstacles to overcome in generating exports. Nonetheless, many of these firms have achieved a relatively high level of external orientation.

1. The Life and Health Insurance Industry

The Canadian life and health insurance industry in particular has achieved a high level of foreign orientation, to the point where it can claim to be the most active internationally of any major Canadian financial services industry.

The industry's success internationally has been attributed to five factors:

- *Management expertise.* In mature markets, Canadian companies are seen as having applied superior marketing, cost control and actuarial skills to their foreign operations. These are skills developed in a competitive and sophisticated Canadian life insurance market.
- *Financial strength.* Canadian companies are well capitalized, have large blocks of core business which generate cash flow, and enjoy good credit ratings. These are advantages in dealing with foreign regulators and customers.
- *Strong regulation and policy support.* In addition to the high prudential standards set by Canadian regulators, foreign trade policy support and flexible regulatory accommodation of international activities were cited as elements supporting the industry.
- *Ability to attract and develop a skilled work force in the target market.* Canadian companies' good reputations, experienced management, and training programs have all contributed to success in foreign markets.
- *A long history and experience in foreign markets.* As long ago as 1900, close to 20 percent of Canadian life insurers' premium income was derived from markets outside Canada. Several companies have major successful operations in the United States and the United Kingdom. More recently,

Canadian companies appear well positioned to pick up business in traditional high-margin products in the emerging markets of Asia through their joint ventures.[139]

2. Banks

The Canadian banks have implemented a variety of strategies in their international activities, cultivating niches where they have developed advantages and skills. For example, while previous forays by the banks into the Eurobond markets proved disappointing, the continuing upward trend in foreign asset orientation reflects growing international business:

- The Bank of Nova Scotia has built a banking network in the Caribbean and more recently participated in joint ventures in Latin America. Scotiabank's foreign expansion has continued with the recent opening of branches in New Delhi, India, and in Guangzhou, China. It also purchased interests recently in a Venezuelan, a Peruvian and an Indonesian bank.
- The Toronto-Dominion Bank has pursued a discount brokerage strategy in the United States, the United Kingdom and Australia. A number of acquisitions have built its operation to the third-largest in the world. TD Securities has also achieved some successes in the Eurobond market.
- CIBC Wood Gundy has established a foothold in New York investment banking with the purchase of Oppenheimer. In securities custody, CIBC has joined forces with Mellon Bank of Pittsburgh to build up a major securities custody operation in Canada, with links abroad. CIBC also has a significant ownership share in Newcourt Credit Group, a large and successful North American leasing company.
- The Bank of Montreal has emphasized a North American approach, with a launching point in the U.S. Midwest through wholly-owned Harris Bancorp, and through its Mexican partner, Grupo Financiero Bancomer. More recently it has begun operations in China.
- The Royal Bank does a considerable amount of loan syndication and foreign exchange business in several U.S. centres and has the largest presence in Europe of any Canadian bank. It has also established a global private banking network.

3. Asset Management

Canadian investment management firms are growing to service a burgeoning domestic market, but are not major participants in international asset management services. Canadian firms continue to handle the bulk of Canadian dollar assets, and profitability is quite high, with returns on equity

[139] Jane McIntyre and Michael Andrews, *Competing Globally: The International Activities of Canadian Life and Health Insurers* (Ottawa: The Conference Board of Canada, 1996).

often over 20 percent, which are among the highest in the financial services industry. However, the globalization of investment management has encouraged the entry of many successful foreign investment counsellors into Canada, such as Templeton and Fidelity. The success of globally oriented asset management firms in Canada and abroad can be attributed to the more effective diversification and wider field of opportunities offered by global capital markets. While some Canadian investment counsellors are successfully managing growing pools of international assets and foreign client lists, most of the international asset management business goes to the established foreign firms.

4. Specialized Financing Companies

A large number of financial companies provide services and support mainly to business in the form of leasing and related services. Being largely unregulated, the larger companies in the sector are characterized by an international outlook and are often owned by or associated with a non-financial parent. Newcourt Credit is the largest independent Canadian-based company. Newcourt arranges vendor financing for industrial equipment and projects ranging from rail, aerospace, and natural gas storage to toll highways and high-technology equipment; it securitizes the great majority of the financings. With its recent takeover of AT&T Capital, Newcourt now has operations in 24 countries, and the great majority of its loan origination is from outside Canada. It often forms joint ventures with its larger industrial clients. Loan originations have grown more than ten-fold over the last five years.

Prospects for the Competitiveness of Canadian Financial Institutions

An increasingly interdependent world economy implies more trade, services and financial flows among countries. The financial services sector is no exception to this trend. The World Trade Organization (WTO) agreement on trade in financial services was proclaimed in December 1997. The agreement will eventually bring such services trade within the ambit of a rules-based trading framework.

As globalization continues, national economies (including that of Canada), will find that international trade in financial services will constitute a larger part of the economy. Sales of Canadian services to foreign clients and purchases of financial expertise, products and services from foreign service providers will become more common. Which way the balance of trade in financial services will turn depends on the competitiveness of the Canadian financial services sector and the strategic initiatives it will undertake.[140] The availability of

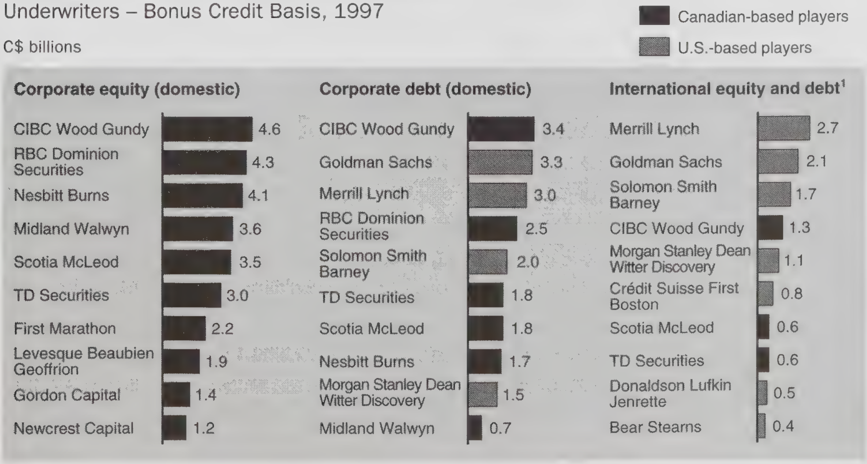
[140] Published data on financial services trade indicate an annual deficit of a little over $1 billion in recent years (Statistics Canada, cat. no. 67-203). The data include mainly insurance premiums and claims, banking service fees and securities commissions.

competitively priced Canadian and foreign-based financial products and services will contribute to the efficiency and competitiveness of the economy as a whole, since virtually every sector and individual is a user of financial services.

Investment Banking and the Evolution of Global Capital Markets

Globalization and technology are having their greatest impacts in relation to investment banking. The ease and the costs of communication are improving dramatically, enabling services to be provided from various locations. At the same time, scale economies, capital requirements to be a global investment banker, networking efficiencies, and access to human capital have led to the consolidation of global finance in world financial centres such as London and New York. In terms of institutions, the provision of global investment banking services is also becoming consolidated in the hands of a small number of global players. Toronto, in this framework, is an important regional financial centre, and Canadian financial service companies are sizable and profitable but do not rank in the top tier. For example, in bringing Canadian corporate clients to international equity and debt markets in 1997, U.S.-based Merrill Lynch, Goldman Sachs, and Salomon Smith Barney ranked first, second and third respectively. CIBC Wood Gundy ranked fourth. Even in domestic debt issuance, Goldman Sachs and Merrill Lynch ranked second and third (see Exhibit 5.5).

Exhibit 5.5
Activities of Securities Underwriters in Canada
Underwriters – Bonus Credit Basis, 1997



[1] Canadian issuers of international equity and debt.

Sources: McKinsey & Company; *The Financial Post*.

It is difficult to point to any forces at this time which would lead to the emergence of a Canadian global financial centre or Canadian financial companies as truly global institutions in investment banking and capital markets. Canadian banks, along with their securities dealers, will probably continue in the immediate future to develop their second-tier strategy of cultivating niches where they have an advantage or expertise. It is possible that in the future the complexion of the financial industry will change to render niche players and specialists more competitive than the large institutions. But in the meantime, the needs of Canadian corporate participants in global capital markets will probably continue to be met mainly by the large international service providers.

It is interesting to note that, while London is unquestionably a centre of global finance, there are at present no U.K.-based institutions among the top tier of global investment banks active there.[141] However, there are large, efficient and profitable domestic service providers, such as Lloyds TSB, as well as leading international asset management firms in the United Kingdom. In the competitiveness survey noted earlier, the United Kingdom ranks first in sophistication and in openness to foreign banking.

In its study for the Task Force, McKinsey & Company sees the niche and focus strategy as achievable for Canadian investment dealers:

> Beyond the strategic position characterized by global presence and full service – dominated by Goldman Sachs, Merrill Lynch, and Morgan Stanley – there are still strategic spots for Canadian dealers to play. Canadian firms, both domestically and abroad, are constrained only by the skills they are able to assemble and retain in the strategies they pursue.[142]

Retail and Consumer Banking

Canadian banks have a number of strengths. The most obvious are physical location and brand recognition, coming from the banks' branch networks and the historical visibility of the banks. Banks can offer one-stop shopping for many financial services. It is unlikely that foreign institutions will start up new operations in Canada to compete directly in offering a menu of traditional retail banking services on a nationwide basis.

As discussed later in the section on technology spending, Canadian banks have developed innovative and competitive retail banking technologies which offer a wide range of automated banking technologies, including bank machines, point-of-sale terminals, telephone banking, Internet banking, and automated

[141] A possible exception is HSBC Holdings, which is more a "global local" bank involved in national markets. Lloyds is domestically oriented and Natwest recently retrenched.

[142] McKinsey & Company, *The Changing Landscape*, pp. 55, 56.

brokerage order entry. These alternative delivery channels will pose a challenge to the banks with regard to how they utilize and integrate their traditional branch networks with the new channels in the delivery of their services.

A number of factors may threaten the consumer franchise of the Canadian institutions. In the U.S. market, the emergence of “monoline” institutions has taken away substantial market share from traditional multi-line banks. The monolines are single-product specialists which achieve competitive advantage from their focus on their area of strength, through economies of scale and massive spending on up-to-date technology. Examples of such firms are Capital One and MBNA in credit cards,[143] and Countrywide Credit Industries in mortgages. These firms originate business in their market segments and finance the resulting loans through securitization. Newcourt Credit Group, a Canadian-based leasing specialist expanding worldwide, follows a similar strategy.

While traditional multi-line banks are unlikely to pursue retail branch-oriented strategies in Canada, the foreign single-product specialists are entering the Canadian market. It is too early to tell whether these operations will be profitable enough to encourage further entry. At present, market shares are still small. However, such activity does confirm that these market segments are contestable, and if U.S. experience is any guide, these specialist companies will soon become important competitors in the Canadian market.

In several cases, new entrants are taking advantage of alternative delivery systems relying on new technology to get around the absence of a dedicated branch system and the relatively high costs of traditional service. Discount brokerages encourage automated order entry by offering dial-up and Internet services at lower commission rates than traditional manual order taking. ING Bank of Canada solicits deposits without a branch network, and call centres are used by both Canadian-based and new foreign entrants to distribute products.

Insurance

The life and health insurance industry has a good base for competing internationally. In its traditional mature markets such as the United States and the United Kingdom, expansion may continue through acquisition. For example, Manulife Financial has a strong international re-insurance operation and is among the leading U.S. firms in group pension services to small and medium-sized business; Great-West Life continues to make successful acquisitions in the United States; Sun Life has a good American distribution network and an important fund management operation; and Canada Life recently purchased

[143] In the United States, MBNA grew its market share among the top 10 issuers from 7.8 percent to 12.0 percent over the five years ending in 1996, and Capital One grew from a small share to 5.1 percent. Over the same period, Citicorp's share fell from 32.2 percent to 22.1 percent. *Card Industry Directory* (New York: Faulkner and Gray, 1998).

the U.K. operations of New York-based Metropolitan Life. Canadian companies have also put an increasing focus on the underserved and developing markets of Asia, where entry has been achieved through start-ups and joint ventures. Manulife operates in nine Asian countries.

Challenges to the Canadian life and health insurance industry are the maturity of its home market with limited capacity for growth, the emergence of lower-cost competing distribution channels, and access to capital. Demutualization of mutual insurance companies will be very important with respect to increasing access to capital, thereby permitting them to grow and diversify.

Technology Spending

An argument often made by Canadian and foreign financial institutions is the need to develop and apply leading-edge technology as a particular competitive strategy. Information technology budgets for Citicorp and Chase Manhattan – spending leaders – are estimated to have approached US$2 billion each in 1997. Another handful of major U.S. and European banks are estimated to be spending well over US$1 billion. By comparison, the largest Canadian banks are estimated to be spending in the range of US$400 to US$600 million per year – not enough, it is suggested by some, to move to the leading edge. These massive budgets can be sustained only by the largest institutions, which tend to be the large money centre and investment banks active in capital markets.

An aspect of information technology spending by existing institutions is the extent to which the spending represents new and improved technology. A considerable part of Canadian institutions' spending is likely to be associated with the maintenance of "legacy" systems, existing systems which must be operational to continue the institutions' day-to-day business. Spending on legacy systems tends to have first claim on the information technology budget, because such spending is necessary to maintain and provide needed enhancements to existing services. Such investment is relatively low-risk, because the existing system is known to work and employees are familiar with it and so do not require a great deal of training. However, this spending does not provide leading-edge services and their related cost efficiencies. Spending on new replacement systems is expensive and must be justified as an additional cost to the budget while legacy systems are maintained and eventually phased out.[144]

The volume of spending alone, however, does not guarantee technological superiority. The ability to focus state-of-the-art technology to gain superiority in a particular market niche is one reason why new specialist entrants in the

[144] Moreover, the spending is higher-risk. If the new system works and other parts of the business plan for which the new system is designed fall into place, the plan is a success. However, if the system does not work as expected, the sunk cost may not be retrieved.

United States (such as MBNA in credit cards and Countrywide in mortgages) have been successful. In addition, these new entrants do not have legacy systems to maintain and are not burdened by technology spending required to remedy the "Year 2000" problem.

While Canadian institutions are not spending at the rate demonstrated by the leading global firms active in international capital, foreign exchange and derivatives markets, all major banks have introduced and developed high-quality retail banking service systems at the branch level, as well as electronic delivery systems. In addition, mbanx (Bank of Montreal) and Citizens Bank (Vancouver City Savings Credit Union) are examples of stand-alone businesses of existing institutions that offer a wide range of branchless computerized banking services. Canadian institutions have been active in pursuing opportunities in the technology field. The Business Development Bank of Canada is unveiling an Internet-based commercial loan service. Some banks have been involved in development of cryptography, digital signatures and network firewalls, technologies which provide security features necessary for electronic and Internet banking.

An Ernst & Young report on technology and financial services prepared for the Task Force concluded that the rate of adoption of new technologies by Canadian banks is comparable to that in the other major countries examined.[145] It did not see regulation as having hindered the adoption of new technologies so far, but it noted a need for a legal and regulatory framework to support electronic commerce in the future, through such specific measures as standards for digital signatures, data security, and document digitization and storage. Looking forward, the report notes that the challenges to Canadian institutions are consolidation abroad in financial services and the emergence of technologically advanced and focussed niche-oriented competitors.

A second phase of the Ernst & Young study involved a series of interviews with executives of major Canadian and U.S. institutions. This research revealed that the enabling factors for the adoption of new technologies in Canada have been public acceptance, a competitive environment, a willingness by financial institutions to adopt common standards, and a strong national banking system with sufficient scale to allow technology investments. The financial industry in general was seen as falling behind in the use of state-of-the-art technology. Within the industry, large money centre banks were seen as the leaders in the adoption of technology, while smaller, regionally focussed institutions were the laggards. Impediments to the adoption of new technology were the lack of experienced human resources and of leadership to define and implement innovative business solutions.

145 Ernst & Young, *Canadian Financial Institutions and their Adoption of Technologies*, Research Paper Prepared for the Task Force (Ottawa, September 1998).

Size and Efficiencies

The size, scope and reach of a financial institution are often referenced in an analysis of its international competitiveness. Several aspects of the size factor emerge in these discussions[146]:

- *Economies of scale.* Size allows a firm to spread out fixed costs over a larger volume of business, and to take advantage of standardized processes. There are distinct segments of the financial services business where economies of scale are clearly evident – for example, the processing of payments, where even large banks find it economic to contract this function out to specialists or set up joint ventures with other institutions.[147] Securities custody is another area which is now dominated by a handful of technologically very advanced global custodians with a network of national sub-custodians.
- *Economies of scope.* On the supply side, such economies relate to the sharing of overhead and technology in the production of different but related groups of services.
- *Operating Synergies.* Efficiencies of scale and scope are static concepts that relate cost to size, and a variety of product offerings, at any point in time. Merger proponents also point out that mergers are dynamic undertakings where success depends on entrepreneurial innovation, leadership, cultural fit, and change management skills, among other things. Mergers offer opportunities to achieve either cost savings through the elimination of duplicative functions or revenue gains through the ability to broaden the product range or customer base in a way that allows effective cross-selling.
- *Technology spending.* With size, larger research and development budgets can be brought to bear on technological solutions and on leading-edge development. The efficiencies of a technological solution to a business problem can be leveraged over a greater volume of business. This is a specific example of an economy of scale.
- *Access to a large capital base.* Large bought deals and global public offerings of securities need the backing of large amounts of capital and strong distribution resources. The large capital base is necessary because investment banks assume risk related to the issue. In syndicated security issues and

[146] From the point of view of an individual company, size offers some protection from takeovers and, if accompanied by a high price/book value multiple for its stock, enhances the company's ability to take over others. But this does not seem to be relevant for the operational competitiveness of the company or the sector.

[147] One example is Symcor, the joint venture formed by the Bank of Montreal, the Royal Bank and the Toronto-Dominion Bank in 1996. This firm is able to sell its high-volume processing services to outside clients as well.

loans, the lead manager is typically chosen on the basis of size, distribution reach, track record, innovative financing concepts, and quality of personnel, and is rewarded with the greatest share of the profit.

However, other areas of the financial sector continue to operate without much indication of the need for scale economies – traditional retail consumer and mortgage lending, for example, where local credit unions remain quite competitive. Even in investment banking, where a small group of global firms dominates, some boutique-leveraged buyout and hedge fund firms have been successful. The nature of the business lines involved is therefore significant in the assessment of the importance of size.

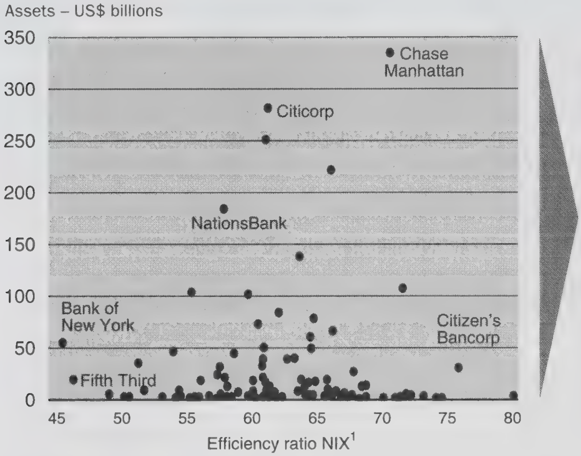
Most research has concluded that economies of scale and scope are limited for large financial institutions. From a survey of the literature covering 23 different studies, Walter (1997) found that economies of scale do exist for small institutions up to about $5 billion in assets.[148] However, he concluded that for a traditional large multi-product bank, efficiency gains from growth in size are limited. While most of these studies were U.S.-based, four were international. Neither were economies of scope found to be important; in fact, in some instances movement into new products was associated with cost increases.

In work prepared for the Task Force, a sample of 125 U.S. banks revealed no clear relationship between efficiency and size (see Exhibit 5.6). Neither did there appear to be much correlation between the size and efficiency of the six major Canadian banks (see Exhibit 5.7). In a sample of international banks, there was no relationship either between size and returns to shareholders (see Exhibit 5.8). In the Canadian life insurance industry, the returns on equity for the largest companies in recent years exceeded the industry average, but in the United States, where the top companies are much larger, they fell below the industry average (see Exhibit 5.9).

Conclusions based on historical research must be approached with some caution and have to be blended with the dynamics of today's fast-changing marketplace. The obvious success of new specialist service providers in the United States, constant technological innovation, and the wave of mergers themselves lead toward a rethinking of this issue. In the United States, in particular, the Interstate Banking and Branching Efficiency Act (the "Riegle-Neal Act") of 1994, may have facilitated the cost-reducing impacts of bank mergers. As noted earlier, Chase Manhattan, for example, has made impressive improvements in

[148] Ingo Walter, "Universal Banking: A Shareholder Value Perspective," *Financial Markets, Institutions, and Instruments* (New York: Salomon Center, New York University, 1997).

Exhibit 5.6
Relationship Between Size and Efficiency – U.S. Banks
Top 125 U.S. Banks, 1996



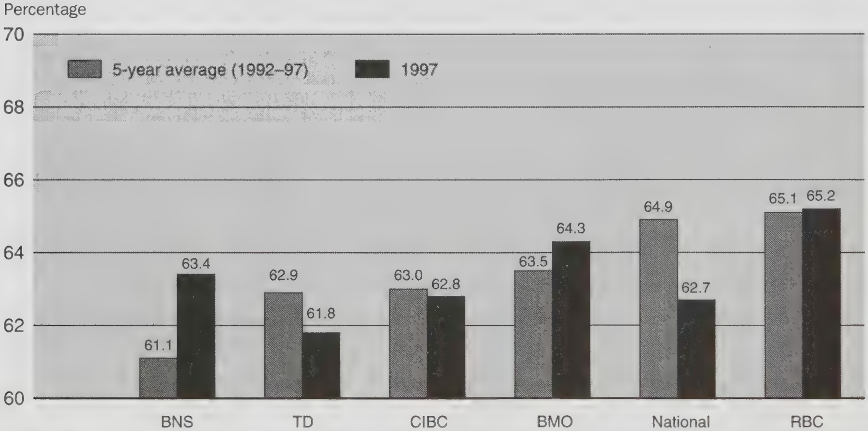
Potential scale advantages may not be captured

- Management failure
  - –Lack of will/skill to get cost out
  - –Lengthy/problematic merger integration (if applicable)
- Competitors outsourcing scale-driven operations
- Already beyond efficient scale
- Brand advantage not relevant

[1] Non-interest expense/operating revenue

Source: McKinsey & Company Global FIG Practice.

Exhibit 5.7
Size and Efficiency – Canadian Banks
Efficiency Ratios



	BNS	TD	CIBC	BMO	National	RBC
Asset rank	4	5	2	3	6	1
Efficiency rank, 5-year average	1	2	3	4	5	6

Sources: McKinsey & Company; The Financial Post database; annual reports.

Exhibit 5.8
Size and Return on Investment

Market cap rank	Bank	Market cap at 97/12/13 US$ billions	Compound annual growth rate in total shareholder return, 1992–97	Average returns
1.	Lloyds TSB	69.9	42.1	22.1% (ranks 1–12)
2.	Tokyo-Mitsubishi	64.7	-5.1	
3.	Citicorp	57.9	51.7	
4.	BankAmerica	50.6	26.4	
5.	Chase Manhattan	46.2	31.4	
6.	HSBC Holdings	44.4	35.5	
7.	NationsBank	43.2	20.1	
8.	Barclays	40.5	27.4	
9.	Deutsche	37.5	11.3	
10.	Sumitomo	36.0	-5.7	
11.	First Union	32.2	22.7	
12.	Banc One	31.9	9.4	
13.	Union Bank Switzerland	30.7	19.8	23.1% (ranks 13–25)
14.	Crédit Suisse	30.2	24.0	
15.	Sanwa	29.5	-8.4	
16.	Wells Fargo	29.4	29.4	
17.	Norwest	29.3	27.3	
18.	National Westminster	28.8	24.1	
19.	ABN Amro	27.5	25.0	
20.	Abbey National	25.3	24.4	
21.	First Chicago NBO	24.3	18.8	
22.	Swiss	24.1	22.6	
23.	Dresdner	24.1	17.2	
24.	BNC Bilbao Vizcayer	21.9	32.8	
25.	Bank of New York	21.8	39.9	
			Average 22.6%	

Sources: McKinsey & Company; *The Banker;* Datastream.

Exhibit 5.9
Return on Investment of Five Largest Life Insurers – Canada and U.S.
Top 5 Players

Percentage

Canada 1993–96		U.S. 1993–95	
Sun Life	6.4	Prudential	3.5
Manulife	9.7	Northwestern Mutual	8.2
Great-West	11.4	New York Life	9.0
Canada Life	7.5	Metropolitan Life	4.9
London Life	8.9	ITT Hartford	8.3
Industry Average[1]	6.1%	**Industry Average**[2]	10.3%

[1] Based on average return on equity for Top 20 firms in Canada.
[2] Total U.S. life and health insurance industry average.
Sources: McKinsey & Company; *Moody's Industry Outlook; AM Best.*

its operational efficiency. A summary on the subject of size and scale from the San Francisco Federal Reserve captures these thoughts well:

> In the U.S. banking industry, researchers [have] detected economies of scale, though the optimal scale appears to differ for large banks and smaller banks due to their very different product mix. They also suggest that the optimal size of large banks is well below that of today's megabanks. However, that finding may be obsolete given the dynamics of the banking industry. With significant regulatory changes, rapid technological breakthroughs, and constant product innovations, the right size for yesterday's environment may no longer be optimal today, much less for the future. More importantly, researchers find that X-efficiencies, that is, deviations from the cost-efficient frontier, on average are large and dominate scale efficiency. Hence, it may be more fruitful to achieve efficiency gains by doing things right rather than by searching for the right scale.[149]

To conclude, it seems that certain business lines do exhibit operational economies of scale, but there is no discernible evidence of better cost performance at the overall firm level for large firms. The unobserved costs of higher overhead and inflexibility may offset the measurable advantages of size and prevent management from harnessing those advantages. Profitability may be enhanced through a better mix of output.

The larger Canadian institutions would appear to be in the size range where, based on the evidence from historical research, most efficiencies from size have already been realized. But the dynamics of today's business environment may be changing the relationships between size, costs and profitability. The nature of the business line is important in the economies of scale discussion, and the efficiency of operations themselves may be more important than size.

Policy Implications

Policy implications for international competitiveness are guided by two principles:

1) Canadian regulatory policies should not unduly restrict Canadian institutions in Canada and abroad from competing with each other and with foreign competitors. Competition is one of the key tools for ensuring that Canadians are well served.
2) As far as possible, the policy environment should preserve the safety and soundness of the Canadian financial services sector.

The Task Force feels that modifications to three aspects of the policy environment would enhance the international competitiveness of the financial services sector: accounting issues, taxation and merger reviews.

[149] Federal Reserve Board of San Francisco, *Economic Letter* (February 28, 1997).

Accounting Issues

The Discussion Paper of the Task Force invited comment about any differences between accounting standards in Canada and those in other nations that might adversely affect the Canadian financial services sector. In response, many submissions pointed to serious concerns which arise from the different accounting treatment of business combinations in Canada and the United States. Others commented more generally on the importance of maintaining common accounting standards between Canada and the United States.

When a business combination occurs, generally accepted accounting principles determine whether the transaction will be accounted for using the pooling of interests or the purchase methods of accounting. If the purchase method of accounting is applicable, any goodwill associated with the business combination is valued and set up as an asset on the balance sheet of the acquirer or, in the case of an amalgamation, on the balance sheet of the ongoing entity. Under the pooling method of accounting, the assets of the combining companies continue to be recorded on the books of the combined entity at their book value. No goodwill is recognized.

Where purchase accounting is applicable, the further accounting issue must be addressed as to how the goodwill asset is to be treated for income statement purposes. If the goodwill is written off, there will be a negative impact on the company's earnings in the year or years of the write-off. The amortization expense associated with the write-off of goodwill is, of course, a non-cash item and corporate cash flows are not affected by goodwill write-downs.

Accounting principles in different countries take different approaches to business combination accounting and to the accounting treatment of goodwill. The Task Force has been advised that U.S. generally accepted accounting principles are very liberal in respect of business combination accounting standards. Pooling accounting, where no goodwill is recognized, can often be achieved in the United States by a careful structuring of a business combination. In Canada, on the other hand, pooling is available in only very limited circumstances (essentially, the Canadian rule is that pooling is available only where it is not possible to identify an acquirer and the transaction may reasonably be characterized as a merger of equals). Under Canadian generally accepted accounting principles, goodwill arising out of a merger is written off in future periods over its estimated useful life. Under the accounting standards of some other countries, acquisition goodwill is recorded on the balance sheet at the time of the transaction, but the write-off is either deferred until it is evident that there is an impairment of the asset value or else it is taken immediately as an extraordinary item.

The Canadian treatment of business combinations and goodwill, taken together, have a negative impact upon the ongoing stream of accounting earnings of most enterprises undertaking business combinations. It limits pooling accounting to extraordinary cases. In addition, it requires that goodwill be recognized on the balance sheet at the time of the transaction and amortized on an annual basis. The result is to diminish the accounting earnings of Canadian enterprises for a number of years following many business combinations. That result would not occur if the transactions could be accounted for using pooling accounting as in the United States (in which case there would be no goodwill), or if goodwill amortization rules applicable in other countries were available in Canada.

This is no academic difference. The share values of Canadian public companies are determined, at least in part, by market perceptions of their earnings and the trend lines of those earnings. Reduced earnings arising out of acquisition goodwill will constrain share values, which in turn will stifle the growth of Canadian-based financial institutions by increasing their cost of capital. In addition, decreased market values will make it cheaper for others to successfully acquire Canadian companies in takeover bids, and will diminish the value of the shares of Canadian companies as acquisition currency. In a period of industry consolidation, these accounting rules can also inhibit consolidations among smaller institutions which might produce vibrant competitors in the Canadian financial services marketplace.

Representatives of the Canadian Institute of Chartered Accountants (CICA) presented a submission to the Task Force and met on several occasions with Task Force members and staff to discuss the issues. It is not the role of the Task Force to comment on the technical merits of the various approaches to the determination of accounting income employed in other countries. In its submission, the CICA advised the Task Force that the United States "appears to stand alone in permitting widespread use of pooling." However, the Task Force is persuaded that there is a competitive imbalance of serious proportions arising from differences between Canadian and U.S. accounting practices. The United States is our largest trading partner, and many competitors of Canadian financial institutions have a U.S. base. The increasing development of an international financial services market and the wave of consolidation sweeping through the industry make it imperative that the issue be addressed promptly.

The accounting profession and regulators in the United States are re-assessing the accounting practices applied to goodwill and business combinations. Those efforts may well produce changes in the accounting rules that will move them closer to the present Canadian position, thereby removing the competitive advantage which U.S. firms presently enjoy. The Financial Accounting Standards Board of the United States has indicated that it expects to issue an

exposure draft early in 1999, although it may be restricted to the goodwill amortization issue, with the business combination accounting question to be dealt with later. There is no clear indication as to when U.S. generally accepted accounting principles may be changed or what proposals may eventually be adopted. The Task Force was advised that the changes may not be made for a number of years.

It would not be prudent to ignore these issues and to rely on this reconsideration in the United States, the timing and results of which are so uncertain, to level the playing field and solve the problem. Delay could compromise efforts of Canadian firms to maintain and improve their international competitiveness. Delay could also jeopardize Canadian business combinations which would significantly improve competition in the domestic marketplace.

The Accounting Standards Board of the CICA has informed the Task Force that it is continuing to assess Canadian accounting practices for business combinations in light of the problems which are being encountered. However, it has also indicated that an interim solution is not likely to be forthcoming.

The Task Force recognizes that it may be difficult for the CICA, for reasons of accounting principle or due process entailed in standards review, to make the needed changes to Canadian accounting principles in a timely way. If the accounting profession cannot satisfactorily respond to the problem or is delayed in finding an acceptable solution, the Task Force believes that OSFI should use its power to specify accounting principles so as to remove the competitive anomaly between Canada and the United States.[150] An OSFI determination of accounting principles would have obvious limitations in that it would apply only to federally incorporated financial institutions.

Speaking more generally, the Task Force urges the Canadian Institute of Chartered Accountants to be very sensitive to the international competitiveness of Canadian financial institutions as it goes about its ongoing work of refining accounting principles. It is, of course, important that Canadian practices should be appropriate so as to fairly present the financial positions of Canadian companies. However, it is also important to recognize that reported earnings are very important to public companies in an era of consolidation and change. The competitiveness of Canadian companies can be adversely affected by accounting standards in Canada which differ from those in the United States. The Task Force therefore encourages the CICA to develop its standards in a way that takes full account of developments in the United States and internationally.

[150] In July, OSFI indicated that it would propose changes that would make merger accounting practices for federal financial institutions more consistent with U.S. rules.

Taxation

The taxation of financial institutions is a major factor in their competitiveness. In discussing barriers to entry, it was pointed out how the various federal and provincial capital taxes on financial institutions can make it extremely difficult for new entrants to compete with existing institutions, and the Task Force has proposed a capital tax holiday for new institutions to help overcome this difficulty.

This section considers taxation more generally, as it affects existing participants and (in particular) as it differentiates among them.

In the Discussion Paper released in June 1997, the Task Force commented:

> While we recognize the potential importance of these [taxation] issues, we question whether they can be dealt with in isolation from other aspects of the tax system and we are reluctant to embark on a study that might lead us into much wider questions. There is a Technical Committee on Business Taxation established by the Minister of Finance to advise on tax matters in the corporate area. Jointly with that Committee, we have commissioned research to identify aspects of the tax regime affecting financial institutions that may give rise to public policy concerns. The results of that research will be public. We do not currently intend to deal with tax matters in our report.[151]

The Technical Committee concluded, with respect to financial institutions:

> ...as long as the financial services sector is under broad review by the Task Force and by the government, we should make no recommendations nor suggest any policies that would significantly alter the level of tax revenues currently derived from the financial sector under the existing tax regime.[152]

However, the Technical Committee went on to say:

> Subject to the report of the Task Force, and within the overall restraints imposed by budgetary needs, and also with due regard to changes in regulation and organization of the industry, the government should move toward equalizing the tax burden of companies in this industry with the general corporate sector. More specifically, we suggest that capital and income taxes on financial institutions be adjusted over time to be comparable with those imposed on other large corporations in other industries.[153]

The research report prepared for the Task Force and the Joint Committee concluded:

151 Task Force, *Discussion Paper*, (Ottawa, June 1997), p. 41.

152 *Report of the Technical Committee on Business Taxation*, submitted to the Hon. Paul Martin, P.C., M.P. Minister of Finance, December 1997, p. 5.36.

153 Ibid., p. 5.37.

> ...there is significant evidence to support the conclusion that the current level of taxation on the financial service sector in Canada is excessive relative to both the non-financial sector in Canada and the foreign competitors with which Canadian financial service providers increasingly compete. More importantly, all the signals are that the financial services environment will become even more competitive (both domestically and internationally) and the current tax system in Canada does not leave our financial institutions well-positioned to deal with this increased competition.[154]

The Task Force recognizes that taxation is complex. The level, structure and overall impact of taxation is determined by many factors including governments' revenue objectives, particular characteristics of the sector being taxed, and the interaction of uncoordinated tax measures levied by provincial and federal governments. Nevertheless, taxes do matter and the Task Force, having reviewed the submissions of many groups as well as the research report, feels compelled to comment on a number of important tax issues that it believes governments should address as quickly as possible. This is particularly relevant now that governments have achieved or will soon achieve a fiscal position that provides some room to act.

1. The Overall Level of Taxation

The overall tax burden on the financial sector has been increasing rapidly and is substantially higher than the tax burden on the non-financial sector. For example, The Conference Board of Canada reports:

> Despite strong overall corporate performance in 1994, 1995 and 1996, financial institutions continue to pay a substantially higher proportion of the income tax payments made by the corporate sector (over 19 percent) than would be expected based on their proportion of either revenues (almost 6 percent) or profits (slightly more than 17 percent).[155]

Similarly, a recent study by Statistics Canada indicates that the financial sector accounted for 25 percent of all corporate taxes paid in 1994 (compared with 14 percent in 1988) and only 12.5 percent of total operating revenues. From 1988 to 1994, the financial sector's contribution to total corporate taxes roughly doubled, whereas the contribution of the non-financial sector increased by 5 percent.[156]

[154] Kevin J. Dancey, *Impact of Taxation on the Financial Services Sector*, Research Paper Prepared for the Task Force and the Technical Committee on Business Taxation (Ottawa, September 1998), p. 6.

[155] Kimberly Birbeck and Pierre Vanasse, *Supporting Governments: Transfers from Financial Institutions to Governments, 1997 Edition*, Report 230-98 (Ottawa: The Conference Board of Canada, 1998), p. 15.

[156] Dancey, *Impact of Taxation*, p. 12.

The major factors leading to the relatively high level of taxation in the financial services sector are the imposition of special taxes on capital by the federal and provincial governments, taxes that do not apply to other sectors, and the imposition of premium taxes on insurance companies by provincial governments.

2. Capital Taxes on Financial Institutions

Financial institutions are subject to two separate federal capital taxes and varying rates of capital tax in every province.

At the federal level, the Part I.3 large corporations tax applies to all corporations with capital in excess of $10 million. The current rate is 0.225 percent, having been increased in 1995 from 0.2 percent. Virtually all financial institutions are liable for Part I.3 tax.

The second federal capital tax, Part VI tax, is levied on regulated financial institutions only, and only on their capital in excess of $200 million. The rates are 1.0 percent on capital between $200 million and $300 million, plus 1.25 percent of capital in excess of $300 million. The Part VI tax was introduced for deposit-taking institutions in 1986 and extended to life insurers in 1990. In 1992, life insurers were subjected to an additional Part VI tax. The effect is to make the tax progressive for life insurers, with Part VI rates ranging from 0.5 percent on capital over $10 million to 1.5 percent on capital over $300 million.

In 1995, the federal government introduced a temporary surtax of 12 percent of Part VI capital tax. Originally scheduled to be in effect until October 1996, it has been extended until October 1999.

Neither the Part VI tax nor the surtax applies to unregulated financial institutions such as Newcourt Credit Group or GE Capital.

Both of the federal capital taxes can be reduced by income tax paid; the "temporary" 12 percent surtax, however, cannot be so reduced. The capital taxes – and particularly the Part VI tax – are designed to act as a minimum tax on financial institutions. The effect of this can be seen in the revenue flows:

- Notwithstanding increases in tax rates since 1991, federal capital tax revenues steadily decreased from $602 million in 1991 to $153 million in 1995, as federal income tax revenues from the financial services sector rose from $1.3 billion to $2.2 billion.[157]
- But federal capital taxes grew in 1996 to $350 million (even though federal income taxes grew as well to $2.8 billion) because of the imposition of the 12 percent capital surtax, which cannot be reduced by income taxes.

[157] Birkbeck and Vanasse, *Supporting Governments*. The description of the tax regime and the data in this section are drawn from this comprehensive report and from the previous year's report (Conference Board Report 175-96) by David Brown and Pierre Vanasse.

Since 1990, all provinces have levied capital taxes. The definitions of the bases vary, as do the rates, and some provinces have introduced surtaxes as well. Rates tend to be in the range of 2 to 4 percent. This translates into total provincial capital tax revenues of $522 million in 1996, up from $375 million in 1991. Provincial capital taxes are deductible from federal corporate income tax.[158] Credit unions are generally exempted from provincial capital taxes. A comparison of capital tax structures for credit unions and banks is shown in Exhibit 5.10.

Exhibit 5.10
Comparison of Capital Taxes

Province		Credit Unions rate (deduction)[1]	Banks rate (deduction)[1]
Newfoundland		Exempt	4% ($5 m, if K<$10 m)
Prince Edward Island		Exempt	3% ($2 m)
New Brunswick		Exempt	3% ($10 m)
Nova Scotia		Exempt	3% ($0.5 m)
Quebec	Capital tax	1.28%[2] ($0.3 m)	1.28%
	Compensatory tax	2.5% wages	0.25% of paid-up capital + 2% wages
Ontario	Capital tax	0.05%[3] ($2 m)	First $200 m: 0.6% ($2 m)
	Additional surcharge	Exempt	Excess: 0.9% 0.09% ($400 m)
Manitoba		Exempt	3% ($2 m)[4]
Saskatchewan		Exempt	3.25% ($10 m)
Alberta		Maximum of $100	2% (variable)
British Columbia		Same treatment + investment allowances + Central credit unions are exempt	K>$750 m: 3% Others: 1% ($1.5 m)[4]

K = capital

1 Normally, the deduction is applied before the provincial allocation.

2 Reserves are not included in the paid-up capital of credit unions.

3 Capital tax is phased in for credit unions: 0.05% in 1998, 0.1% in 1999, 0.2% in 2000, 0.4% in 2001, 0.6% in 2002.

4 This is an exemption, not a deduction.

158 However, Dancey points out that it is stated federal policy that any base changes, rate increases or new taxes introduced by a province are not deductible for federal income tax purposes except in those provinces which have harmonized with the GST or where federal concurrence is obtained that the changes are revenue-neutral. Dancey, *Impact of Taxation*, p. 44.

There are a number of issues related to the structure and level of capital taxation in the industry.

Capital is important for the financial stability of the enterprise. Because the capital tax applies at the margin (that is, to every additional dollar of capital raised), it increases the cost of adding to capital. Kevin Dancey estimates that the after-tax cost of the capital tax in raising new capital is in the range of 1.5 percent of every dollar of capital raised.[159] The capital tax thus creates an incentive for an institution to hold less capital or to hold capital offshore so that it will not be subject to tax. In either case, the tax can lead to behaviour that prejudices the safety and soundness of the institution.

Capital taxes increase the cost of doing business. Dancey estimates that the impact of the capital tax on a loan could be as high as 12 to 13 basis points, a considerable proportion of the spread.[160] Regulated financial institutions bear this cost, whereas unregulated competitors in Canada and regulated competitors in other countries do not. Canada is almost alone in having special capital taxes on financial institutions. Germany and certain Latin American countries have capital taxes but our major competitors do not.[161]

The Task Force believes that capital taxes levied on financial institutions make the institutions less competitive and create risks to their safety and soundness.

The Task Force proposes that special capital taxes on financial institutions, both federal and provincial, be eliminated.

If revenue considerations make it impossible for governments to eliminate these taxes, the Task Force proposes that certain steps be taken to make the tax more acceptable. First, the tax burden should be shifted to the greatest extent possible away from capital and toward profits. Second, the federal government should work with the provinces to define a common tax base related to capital. Third, efforts should be made to define a capital-related tax base that would tax additions to capital very lightly or not at all (e.g., a schedule of capital tax rates that declined to zero at some level of capital appropriately related to the assets of the institution).

3. Transaction Taxes in the Insurance Industry

The cascading of GST, sales taxes and premium taxes adds substantially to the consumer cost of insurance, for both general insurance and group life and health insurance.[162]

159 Dancey, *Impact of Taxation*, p. 32.

160 Ibid.

161 Ibid., p. 43.

162 The discussion in this section is drawn from Dancey, *Impact of Taxation,* pp. 46-48.

For example, in Ontario general insurance companies pay GST at 7 percent and provincial sales tax at 8 percent on repairs to automobiles. These tax costs are not recoverable and become part of the cost of insurance built into the premium. In addition, the premium includes a special 3.5 percent provincial premium tax and is subject to an extra 5 percent provincial retail sales tax. This is a case of tax compounding on tax compounding on tax. The three provinces where the problem is most severe for the property and casualty insurance industry are Ontario, Quebec and Newfoundland. Dancey concludes that the effect of a 3.0 percent premium tax for a property and casualty insurance company is equivalent to a capital tax of between 6 percent and 10 percent, significantly greater than the rate of capital tax imposed on banks and other financial institutions.

The Task Force urges provincial governments, in their budgeting processes, to be sensitive to the interaction of these various transaction taxes and their impacts on consumers.

4. Withholding Tax on Interest Paid or Credited to Non-Residents

Canada levies a withholding tax of 25 percent on interest paid or credited to non-residents. It is reduced to 10 percent under many of Canada's tax treaties. There is an exemption for arm's-length debt of term greater than five years, where no more than 25 percent of the loan is repaid in the first five years.

Because withholding tax, where it applies, applies on the gross interest paid, the withholding tax itself often exceeds the net margin on the loan. In this sense, it acts as a tariff on the flow of capital into Canada, with the effect that non-residents will often refrain from lending into the Canadian market or make the Canadian borrower pay the withholding tax.

It is sometimes argued that because the withholding tax actually precludes foreign financings from occurring, its elimination would not lead to substantial losses in tax revenue. This supposes, however, that the loans are not being made (at higher prices) to Canadian borrowers. Therefore, removing withholding tax would probably lead to some loss of tax revenue, though it is hard to quantify.

The Technical Committee on Business Taxation recommended that the withholding tax exemption for interest payments to arm's-length, non-resident lenders be extended to all indebtedness, regardless of its term.[163]

The Task Force believes that removing the withholding tax for all arm's-length borrowing is an important measure that can increase choice and lower prices for Canadian borrowers. It therefore supports the recommendation of the Technical Committee.

[163] *Report of the Technical Committee*, p. 6.26.

5. Credit Union Taxation

Credit unions are taxed differently, and more favourably, than banks and trust companies with which they compete. They pay federal income tax at the small business rate (12 percent rather than 28 percent) under a formula that is more generous than that for non-financial small businesses and which has the effect of extending the small business rate to virtually all of their income.[164] They are also exempt from capital taxes in most provinces, and even where they have become subject to capital tax (in Ontario and Quebec), it is on more generous terms than the banks and trusts.

Dancey, in his study, notes, "Market conditions exist for credit unions to grow out of the small business tax rate as their capital positions improve and as their product mix changes. For example, members' preferences for mutual funds and other securities instead of traditional deposits could hasten this shift."[165]

The Task Force believes that credit unions generally can provide a vibrant and welcome source of competition for banks. Specific proposals elsewhere in this paper are directed at ensuring that credit unions have the organizational flexibility to become a stronger competitive force. For this reason, the Task Force is not inclined to propose any changes in the federal taxation regime governing credit unions.

There is, however, a particular situation in the province of Quebec that requires attention. The Mouvement Desjardins is the dominant financial institution in Quebec, accounting for 44.0 percent of deposits.[166] Because the Mouvement Desjardins is structured as a cooperative movement, each of the caisses populaires is taxed as an individual entity rather than a branch. As a result, there is a serious competitive inequity between the position of the Desjardins group and its bank competitors, particularly National Bank of Canada and Laurentian Bank of Canada.

In an appendix to its submission to the Task Force, National Bank refers to an estimate of the Canadian Bankers Association that the Mouvement Desjardins pays about $100 million less in federal and provincial income taxes than it would if it were taxed on the same basis as its bank competitors. In 1995, the advantage was about $42 million due to the operation of the Quebec capital tax alone.[167] The capital tax relief announced in the Quebec

[164] In general terms, the small business rate applies until the credit union's tax-paid retained earnings reach 5 percent of amounts owing to members, including deposits and shares. Thus, as deposits grow the scope for continued application of the small business rate increases as well.

[165] Dancey, *Impact of Taxation*, p. 49.

[166] *En Perspective*, Desjardins études économiques, March 1998.

[167] National Bank, *Reflections on the Future of the Canadian Financial Services Sector*, submission to the Task Force (October 1997), p. 17.

government's 1998 Budget, if applied in 1995, would have reduced the tax advantage by $6.4 million in relation to banks such as National and Laurentian with worldwide assets under $100 billion.

The Task Force believes that this is a serious competitive inequity that should be addressed. The proposals it has made to the federal government with respect to the elimination of capital taxes will help in this regard. The Task Force believes that Quebec should also address this issue, perhaps by reducing further the impact of provincial capital taxes on banks.

Merger Review

The evidence on size, scope and economies of scale discussed above does not strongly support the idea that mergers of large institutions necessarily provide business benefits. However, there are enough changes going on in the business environment that one cannot formulate a definitive conclusion. The evidence deals with size itself and not the potential savings stemming from particular mergers which raise different considerations than size alone. A merger is a dynamic phenomenon in which synergies may be realized from the combination of two institutions regardless of size.

Although there are numerous studies of the efficiency effects of mergers, most pertain to the U.S. experience in a period when smaller banks were consolidating on a regional basis. These early studies typically found limited evidence of efficiency gains. Now studies are starting to appear that deal with the more recent wave of "megamergers." Donald McFetridge in his research conducted for the Task Force describes a recent Federal Reserve study that finds that mergers did improve profitability.[168] This did not occur, as one might think, through increased market power or through lower costs, but through changes to improve the mix of product and services offered after the merger.[169]

Each business combination has unique aspects that must be evaluated as part of the decision to merge: rationalizing particular business lines, introducing alternative technologies, building a stronger management team, or adopting a different approach to worker-management relations. The firms' management and their respective shareholders are best placed to judge whether the changes sought through the merger will improve the company's competitiveness.

[168] Donald G. McFetridge, *Competition Policy Issues* (Ottawa, September 1998).

[169] J. Akhavein, A. Berger and D. Humphrey, *The Effects of Megamergers on Efficiency and Prices: Evidence from a Bank Profit Function*, Working Paper 1997-09 (Washington, D.C.: Board of Governors of the Federal Reserve System, 1997).

The role of government is to review the public policy aspects of mergers and ensure that these restructurings are in the public interest. Merger review policy is discussed in Chapters 6 and 7 of this paper.

Chapter 6

Consolidation and Mergers

Consolidation in financial services is taking place worldwide. Industry restructuring through amalgamations, acquisitions, joint ventures and other arrangements is a natural market response to the forces of change and is quite important to the evolution of financial services. Restructuring transactions can lead to efficiencies, provide scale for investment in innovation, and provide scope in the delivery of products and services. These advantages can be passed on to consumers in the form of lower prices, new innovative products and broader choice.

This chapter will examine the consolidation trend, with a view to identifying any trends from international experience. The chapter will then look at consolidation in the Canadian context, explore what the trend means for Canadians and examine what policy implications it has for Canada, particularly in respect of a perceived merger policy of "big shall not buy big."

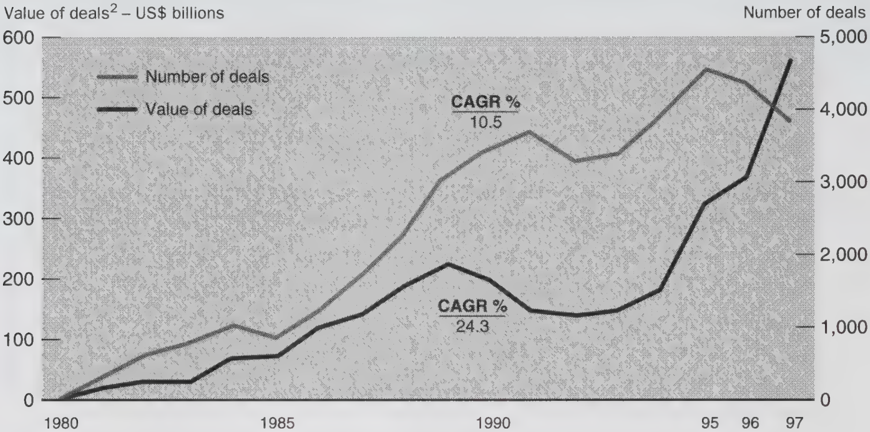
For the purposes of Chapters 6 and 7, mergers include amalgamations, acquisitions of institutions, joint ventures and other business arrangements which result in a combining of all or part of the activities of two separate entities into one business.

Consolidation and Mergers

Although the number of mergers in financial services worldwide continues to grow, the more recent story concerns the size of the mergers involved. Over 4,000 deals annually have been reported in the financial services sector over the last few years. The dollar value of deals has exploded from less than US$200 billion in 1994 to well in excess of half a trillion dollars last year (see Exhibit 6.1). With the mergers announced in the last year, this number is expected to be even higher for 1998.

Mergers tend to fall into one of three categories: in-pillar, cross-pillar or cross-border. In-pillar mergers involve similar financial institutions offering the same or similar products. A key motivation for these types of merger is the search for scale efficiencies. A cross-pillar merger involves institutions offering different ranges of products, such as a bank and a securities firm. A key motivation for this type of merger is the achievement of economies of scope. The merged institution is able to offer a broader range of products and services to

Exhibit 6.1
Worldwide Financial Industry Mergers and Acquisitions[1]



[1] Includes all executed and completed transactions.

[2] Financial institutions include commercial banks, savings institutions, credit unions, non-domestic banks and branches, personal and business credit institutions, mortgage brokers, security dealers and brokers, life insurance companies, and bank holding companies.

Sources: Securities Data Company; McKinsey & Company analysis.

its customer base than its predecessors did. The third type of transaction, cross-border mergers, are transactions between two institutions operating in separate national markets. Efficiencies of either scale or scope can motivate this type of transaction. Exhibit 6.2 provides examples of each type of transaction.

Exhibit 6.2
Examples of Mergers Worldwide

In-Pillar	Cross-Pillar	Cross-Border
• Chase Manhattan Bank (U.S.) and Chemical Bank (U.S.): C$405.96 billion in assets (1996) • Union Bank of Switzerland merger with Swiss Bank Corp: C$907.25 billion in assets (1998) • BankAmerica and NationsBank (U.S.): C$832.20 billion in assets (1998)	• Credit Suisse Group (Switz.) merges with Winterthur Group (Switz.): C$671.58 billion assets under management (1997) • Citicorp (New York bank) announces merger with Travelers Group (insurance, securities, etc.): C$1,021.97 billion in assets (1998)	• Dresdner Bank (Ger.) acquires Kleinwort Benson (U.S.): C$478.08 billion in assets (1995) • Munich Re. (Ger.) acquires American Re. (U.S.): C$12.29 billion in assets (1996) • ING (Neth.) acquires Bank Brussels Lambert (Bel.): C$568.05 billion in assets (1998)

All assets are pro forma; relevant average Canadian exchange rates for the month of June in the relevant year.

In response to these trends, mergers have also taken place and are proposed in Canada. Examples include the following:

- Bank of Nova Scotia acquired National Trust in 1997 (in-pillar);
- London Insurance Group was acquired by Great-West Life (in-pillar) in 1997 after an unsuccessful bid by Royal Bank of Canada (cross-pillar); and
- Canada Life announced the purchase of the operating businesses of Crown Life in 1998 (in-pillar).

In addition, two major bank mergers have been proposed since January 1998.

While the business rationales for the restructuring transactions in financial services are many and varied, the main concern of individual Canadians is how they will be personally affected. For example, they are affected if the transactions result in a significant lessening of competition, if the safety and soundness of the financial system is jeopardized, if employees lose their jobs, or if they lose access to a branch. The role of government is to ensure that major transactions affecting industry structure do not result in a substantial lessening or prevention of competition, do not adversely affect safety and soundness, and are consistent with the public interest.

The role of government in reviewing transactions involving federally incorporated financial institutions will be examined in the next chapter. This chapter will focus on the appropriate policy context for reviewing such transactions. The chapter will therefore examine:

- international consolidation in the financial services sector;
- consolidation in the Canadian context; and
- the so-called "big shall not buy big" policy with regard to mergers and acquisitions.

International Experience with Mergers

Consolidation in financial services is an international phenomenon. This section reviews the experience of four jurisdictions: Australia, the Netherlands, Switzerland and the United States. They were chosen for illustration purposes. The first three are similar to Canada in that they are small countries, have open and developed economies, and are characterized by their small number of large, domestic commercial banks. The United States is included because of the importance of its market to Canadian firms.

Overview of Selected International Experience

1. Australia

Australia does not have a long tradition of financial sector consolidation. While there are examples of acquisitions of troubled banks, as well as periodic industry consolidations, the number of mergers and acquisitions was quite small up until the 1990s. This was largely due to the Australian government's "Six Pillars Policy," which precluded mergers between any of the big four national banks and the largest two life insurers. In addition, the Australian Competition and Consumer Commission defined the relevant banking market as being state-wide, which limited the Big Six financial institutions' ability to acquire or merge with the regional banks in Australia on competition grounds.

The last decade, however, has seen a gradual deregulation of the financial sector in Australia and, as a result, there has been an increasing number of mergers and acquisitions (see Exhibit 6.3). The rationales for these mergers have been to regionalize operations and to acquire a critical mass in order to compete in the global marketplace. In 1996, the major banks controlled approximately 60 percent of transaction accounts in Australia, while the regional banks controlled approximately 20 percent. The remainder is divided between Australian building societies and credit unions.[170]

Exhibit 6.3
Mergers and Acquisitions within the Last Five Years in Australia

In-Pillar	Cross-Pillar	Cross-Border
• Westpac acquires Challenge Bank (1995) • State Bank of South Australia sold to Advance Bank (1995) • St. George Bank merges with Advance Bank (1997) • Westpac merges with the Bank of Melbourne (1997)	• State Bank of NSW sold to Colonial Mutual Life Association (1994) • Metway Bank merges with government-owned SUNCORP insurance and finance group (1996)	• National Mutual Life Association of Australia acquired by AXA SA (1995) • Westpac acquires Trust Bank of New Zealand (1996)

Source: *Financial System Inquiry Final Report* (March 1997).

The recent Financial System Inquiry rejected the so-called Six Pillars Policy.[171] The Australian government decided to end the policy but stated that it would not allow a merger among the four major banks until it was "satisfied that competition from new and established participants in the financial industry,

[170] Roy Morgan Research, as reported in *Financial System Inquiry Final Report* (Melbourne, Australia, March 1997).

[171] Ibid., p. 416.

particularly in respect of small business lending, has increased sufficiently to allow such mergers to be considered."[172]

2. The Netherlands

Beginning in the early 1970s, the Netherlands government had a policy of not allowing mergers and acquisitions between banking and insurance companies or between the big domestic banks. In the 1980s, however, this policy came under pressure from two sources: the approaching European Union agreement and the prospect of a foreign takeover of a Netherlands bank. At the time, the Netherlands financial sector was quite fragmented. This situation presented the Netherlands government with a conundrum, as it was a strong proponent of closer European cooperation but was also concerned about preserving a strong domestic financial sector. It was generally recognized that home market concentration was a preferable strategy for preserving the strength of the Netherlands banks within Europe.

In order to achieve this, the Netherlands government relaxed its stance on mergers in 1987, allowing limited cross-ownership between banks and insurance companies. The remaining restrictions separating banking and insurance companies and preventing mergers among banks were removed altogether in 1990. This cleared the way for a rapid consolidation of the financial sector.

During the short period of 1989-91, two major bank mergers occurred. This was followed by an amalgamation of one of the banks with the country's largest insurance company. Financial institutions have since pursued a very aggressive strategy of foreign expansion. The largest five commercial and savings banks have 81 percent of domestic banking assets.[173] Aside from ING, ABN-Amro and Rabobank, the financial landscape is made up of two savings bank conglomerates, as well as a few small independent banks and about 95 foreign banks.

Exhibit 6.4
Major Consolidations in the Netherlands Market

In-Pillar	Cross-Pillar	Cross-Border
• NMB merges with Postbank to form NMB-Postbank (1989) • ABN merges with Amro Bank to form ABN-Amro Bank (1990)	• NMB-Postbank merges with Nationale Nederlanden to form ING (1991) • Rabobank acquires asset management group Robeco (1997)	• ING acquires major portion of failed Barings Bank (1995) • ING acquires Bank Brussels Lambert of Belgium (1997)

172 Hon. Peter Costello, Treasurer, Australia, in a press release entitled "*Release of the Report of the Financial System Inquiry and Initial Government Response on Mergers Policy*," April 9, 1997.

173 Bank for International Settlements, *67th Annual Report* (Basle, June 9, 1997).

3. Switzerland

The Swiss financial landscape has been in a state of change for two decades. From 1980 to 1992 the number of Swiss-controlled banks fell from 374 to 320, while over that same period the number of foreign banks rose steadily from 99 institutions to 148. The most important development in numerical terms was among the finance companies. Between 1980 and 1989, the number of these institutions increased from 84 to 137; however, by 1992 the number had fallen off to 101.[174]

The most dramatic of the consolidations, however, have been quite recent. In the last two years, Switzerland has seen mergers between the Union Bank of Switzerland and Swiss Bank Corporation, as well as between Crédit Suisse Group and Winterthur Insurance Group. These mergers have resulted in financial groups that rank amongst the largest in the world.

The rationale for these latest mergers is threefold. Swiss financial institutions believe that in order to be a world-class financial institution it is necessary to be big. Swiss bankers also believe that the future will require financial institutions to offer the full range of financial products to their clients in the form of one-stop shopping. Finally, the Swiss retail market is very competitive, and the big three banks in Switzerland have had trouble making money in it for years. It is expected that the consolidation, and in particular, the rationalization of their expensive branch systems, will help the banks realize considerable cost savings.[175]

Exhibit 6.5
Major Consolidations in the Swiss Market

In-Pillar	Cross-Pillar	Cross-Border
• Union Bank of Switzerland merges with Swiss Bank Corp. (1997)	• Crédit Suisse merges with Winterthur Insurance Group (1997)	• Crédit Suisse acquires First Boston (1997) • Crédit Suisse acquires the European equities and investment banking businesses and portions of the Asian banking business of BZW, the investment banking unit of Barclay's PLC (1997)

[174] *Banking in the EU and Switzerland, 1994 – Structures and Sources of Finance*, Management Reports (London: Financial Times).

[175] There is some evidence to suggest that the Swiss market is "over-banked." Switzerland has almost 3,800 branches spread amongst the "big three" banks, 25 cantonal banks, over 150 regional savings banks and co-ops, 150 foreign banks and 17 private banks, all for a country with a population of only seven million. The Swiss market is relatively concentrated, however. For example, in 1996, the five largest banks in Switzerland accounted for about 50 percent of the banking assets; the majority of this will now fall to the newly created United Bank of Switzerland and CSG-Winterthur groups. BIS, *67th Annual Report; Banking in the EU and Switzerland; Financial Times*, December 9, 1997, p. 14.

4. United States

The U.S. financial landscape, which for historical reasons is one of the world's most fragmented, has been experiencing an unprecedented period of consolidation in recent years (see Exhibit 6.6). To a certain extent, this consolidation is a result of the removal of legal barriers to geographic expansion both within and across state lines, which culminated with the passage of legislation in September 1994 to allow nationwide banking.[176] A mix of other motives, has also contributed to consolidations, including the desire to achieve economies of scale and scope, and to compete more effectively with new competitors from abroad and within the United States.

As a measure of the pace of consolidation, between 1980 and 1997, the total number of banking organizations fell from 12,333 to 7,122. This was accompanied by an increased concentration of the market, as illustrated by the fact that the percentage of total deposits held by the top 25 organizations rose from 29 percent to 47 percent over that same period (see Exhibit 6.7). The total value of bank-related mergers in 1997 was US$73.5 billion, roughly double that of 1996, despite the fact that the number of consolidations fell from 357 to 304 between 1996 and 1997.[177] This is partly explained by the record premiums paid for new acquisitions in 1997.

Exhibit 6.6

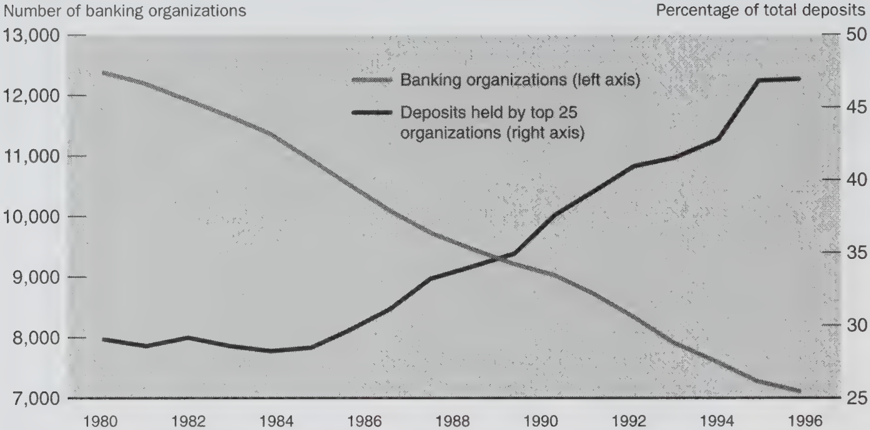
Sampling of Recent Large U.S. Mergers and Acquisitions

In-Pillar	Cross-Pillar	Cross-Border
• Bank America merges with NationsBank (1998)	• Citibank announces merger with Travelers (1998)	• Fleet Financial acquires U.K.-based NatWest Bank (1995)
• First Union merges with CoreStates (1998)		
• Chase Manhattan merges with Chemical Bank (1996)		
• Wells Fargo acquires First Interstate Bancorp (1996)		
• Fleet Financial acquires Shawmutt (1995)		

176 The Interstate Banking and Branching Efficiency Act, 1994 allows nationwide banking through bank holding companies as of September 29, 1995, and nationwide branching as of June 1, 1997, except in states that expressly opt out of the Act's provisions. Virtually all states have now removed or significantly liberalized branching restrictions.

177 SNL Securities LP, as reported in *Banking Strategies*, vol. 74, no. 2 (March-April 1998).

Exhibit 6.7
Industry Banking Structure, 1980–1997



Source: Board of Governors of the Federal Reserve System – Division of Research & Statistics.

Experience Abroad

International experience with consolidation demonstrates that Canadian financial institutions are not alone in facing the pressure to merge. Nor is Canada unique in having to confront the potential policy trade-offs between domestic competition and an internationally competitive financial sector.

The business reasons driving mergers around the world appear to be varied. Merger proponents point to the following:

- *Economies of scale.* Efficiencies achieved by lowering average costs per unit through expanding a line of business;
- *Economies of scope.* Cost efficiencies achieved by offering a broader range of products and services to a customer base;
- *Operating synergies.* Cost savings and revenue gains arising specifically from the synergies of the merging entities;
- *Capital clout.* Developing a stronger capital base to lead or participate in larger and more profitable transactions without putting capital at greater risk;
- *Defence against acquisition.* Achieving a size that acts as a defensive measure against takeovers and buys management time to refocus the business strategy; and
- *Platforms for growth.* An acquisition can lead to an increase in size that creates a platform for further acquisitions.

International experience demonstrates that many firms view consolidation as a valid business strategy. Stock markets have applauded many of the announced transactions, although not all have been received warmly by investors. As noted in Chapter 5, the academic literature is inconclusive about the importance of size to competitiveness. In particular, it is unclear at what point inefficiencies of organizational size begin to outweigh the production efficiencies of scale. It is extremely likely that this point varies from business to business and, for financial institutions, also varies based on their product and service mix.

Still others question the legitimacy of consolidation as a business strategy. Some argue that mergers are the latest business fad and that bigger institutions are not necessarily better. Critics suggest that financial institutions may be so focussed on short-run consolidation strategies that they are missing longer-term opportunities to grow and improve in other ways.

Despite the criticisms, most jurisdictions appear to be willing to allow significant mergers, sometimes with conditions attached to achieve competition objectives or other public policy goals. It is imperative for Canadians to consider the competitiveness implications of policy options that may deny our own institutions the same opportunities.

Consolidation in Canada

The Canadian Context

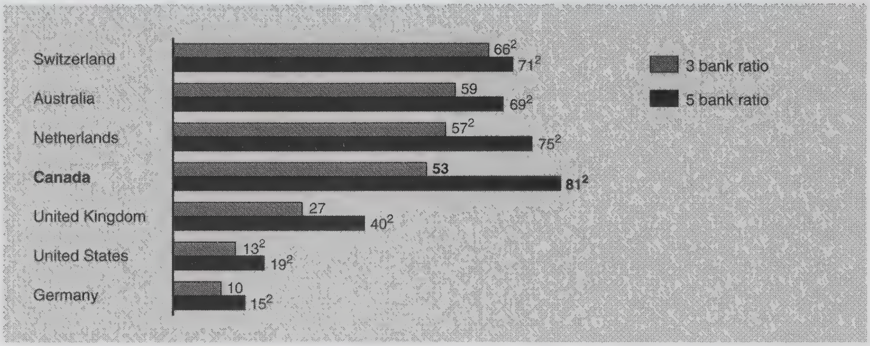
Canada is a large country with a relatively small population. We have 35 metropolitan areas with a population of more than 100,000, numerous small towns and a significant number of remote communities. Despite the geographic challenges, Canadians have benefited from a national market for financial services. For example, Canadians have long enjoyed national pricing on banking services and efficient clearing services coast to coast through the national payments system. This contrasts even today with the experience of our neighbours to the south.

Admittedly, the Canadian financial services sector has had a history of legislative protection from foreign competition, and this has undoubtedly played a large role in the development of our national markets. However, a by-product of this approach is that parts of our Canadian financial sector are relatively concentrated (see Exhibit 6.8). This phenomenon is particularly pronounced in the banking sector.

Globalization, changing consumer demand and legislative change have been eroding the high levels of concentration in Canada over time. For example, as pointed out in Chapter 2, traditional deposit-taking has diminished in importance as Canadians have embraced new savings vehicles. Innovators such as ING Bank and Citizens Bank are making inroads in traditional banking

Exhibit 6.8
Banking Concentration Ratios
Concentration Ratio,[1] 1997

Percentage



[1] Percentage of domestic banking assets controlled by Top 3 and Top 5 banks (by assets) in the country as of December 1997.

[2] 1996 figures.

Sources: *Reserve Bank of Australia Bulletin; Deutshe Bundesbank Monthly Report;* annual reports; ONS financial statistics; Bank of Canada; McKinsey & Company analysis.

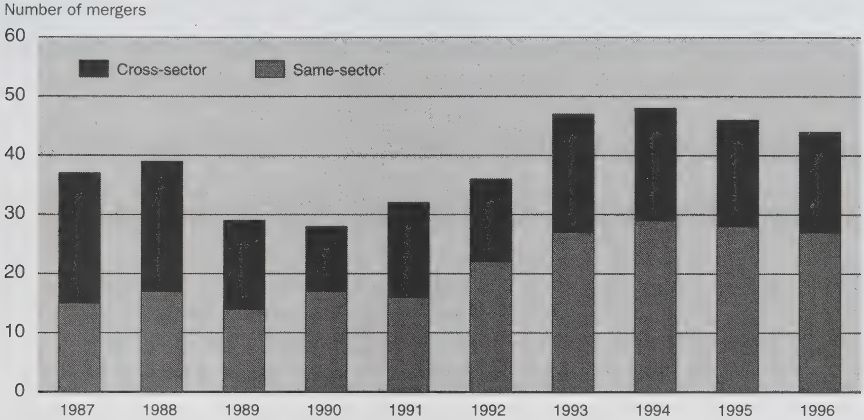
markets through electronic channels, introducing the concept of branchless banking. New product specialists such as MBNA and Wells Fargo will continue to enter Canada and "cherry pick" more attractive retail and small-business market segments, as similar firms have done in wholesale markets such as payroll and global securities custody.

The competitive forces driving change are real. Globalization and the new competitors it brings are forcing Canadian institutions to look at the Canadian market as only part of a much larger market. The focus in financial services is increasingly on a single North American market. However, in light of the trend toward larger transcontinental deals in other sectors, North America may be only an initial stepping-stone for some Canadian institutions to a more global focus in the future. Not surprisingly, Canadian financial institutions are responding to these types of market forces in the same ways as their international counterparts.

As financial institutions size up their growing international competition, they are faced with serious questions about how to position themselves in a globalizing market. Should they narrow their range of services and focus on niche markets worldwide? Toronto-Dominion Bank's focus on discount brokerage services outside of Canada is an example of such a strategy. Or should they reposition themselves as full-service institutions and use their experience to focus on new and emerging markets? Examples are the focus of some Canadian insurance companies on Asian markets, and the Bank of Nova Scotia presence

Exhibit 6.9

Mergers and Acquistions in Canadian Financial Services, 1987–96



Source: The Conference Board of Canada, *The Canadian Financial Services Industry: The Year in Review, 1997 Edition.*

in Latin America. Regardless of which strategies prevail, the need for financial institutions to re-align their businesses to meet growing international competition is a significant factor behind the restructuring taking place in the financial services sector in Canada.

Mergers are among the most visible and, in consequence, among the most controversial strategies to achieve restructuring goals in the financial services sector. While the actual number of mergers in Canada has declined slightly since 1994, the number of transactions per year from 1993 to the present is considerably higher than in the late 1980s, as shown in Exhibit 6.9. The Conference Board of Canada reports over 350 mergers in the Canadian financial services sector in the last 10 years.[178]

Big Shall Not Buy Big

Federal legislation on financial institutions addresses mergers and acquisitions within the financial sector. Provisions essentially allow for mergers among like institutions, such as banks with banks and insurance companies with insurance companies. Federal legislation also permits federally incorporated financial institutions, subject to limitations, to acquire or be acquired by other financial institutions.

The final decision for approving mergers and acquisitions involving federally incorporated financial institutions rests with the Minister of Finance. The

[178] Chris Roth and Hugh Williams, *The Canadian Financial Services Industry: The Year in Review, 1997 Edition* (Ottawa: The Conference Board of Canada, December 1997), p. 10.

Minister's discretion to approve a merger is broad. At present, there is no clear public policy governing what types of mergers would be approved and under which circumstances. However, it is believed that a general policy of "big shall not buy big" has applied for some time. Some evidence of this policy is found in a 1990 government White Paper. It states:

> Because of concerns about potential concentration in financial services markets, in considering whether to approve the purchase of a deposit-taking financial institution (a bank, a trust or loan company) by another deposit-taking institution where permitted under the legislation, the Minister of Finance would take into consideration the size of the target institution and the size of the acquiring institution. Similarly, the Minister would review relative sizes when considering whether to approve the purchase of a federal insurance company by another insurance company.... When a financial institution considers making a purchase of another financial institution engaged in a different business, transactions involving large companies would not be *automatically excluded* [emphasis added].[179]

Experience implies that such a policy does not apply in the case of troubled financial institutions.

Industry restructuring, including consolidation through mergers and other corporate transactions, is a legitimate commercial response to the fast-changing world of financial services. Mergers do not necessarily lead to insufficient competition, or pose safety and soundness concerns. Moreover, they can result in firms that are stronger international competitors, the benefits of which can be shared with Canadians in the form of lower prices, better-quality service and more product choice. Short-term losses in employment can be offset by long-term gains in higher-quality jobs. Mergers, including those among larger institutions, can result in overall benefits to Canadians.

An approach that prejudges merger proposals as unacceptable without examining the costs and rewards is simplistic and not good public policy. Canadians are the ultimate victims of such an inflexible policy.

In its Interim Report to the Secretary of State, the Task Force recommended that:

> a "big shall not buy big" policy, as it affects transactions between entities other than two Schedule I banks, should not have general application and that any such proposed transactions be reviewed for approval on their merits.

Having reviewed the submissions received, the Task Force continues to support this conclusion. The Task Force sees no reason why the conclusion should not be extended to all mergers involving federally incorporated financial institutions, including mergers among Schedule I banks.

[179] Hon. Gilles Loiselle, Minister of State (Finance), *Reform of Financial Institutions Legislation*, fall 1990.

Chapter 7

Merger Review Process

As noted in the previous chapter, industry consolidation in the absence of appropriate regulatory oversight can lead to insufficient competition, thereby hurting consumers. The first line of defence against the negative competition implications of industry restructuring is to remove barriers to entry that prevent new firms from contesting the market. In this way, no firm will be able to exercise market power and earn excessive profit without facing the threat of new competition. This philosophy underpins the proposals made earlier in this paper.

However, as noted earlier, there may be some markets in financial services where the barriers to entry remain high, possibly because of the local nature of the market or the purchasing patterns of financial consumers. While the impact of forces of change in the financial sector may lessen these concerns over the long term, care must be taken to ensure that competition is safeguarded in these areas as unprecedented restructuring of the industry continues.

A merger review process in the financial services sector must look not only at the competition implications of a proposed transaction but also at the impact of the transaction on other public policy objectives, such as safety and soundness. In fact, there are a number of economic and non-economic considerations that arise in the context of a merger in the financial services sector. In deciding whether a merger should be allowed to proceed, it may be necessary to weigh possible trade-offs between competing public interest objectives.

In its Interim Report issued on July 11, 1997, the Task Force recommended a basic framework and process for financial sector mergers. The report concluded that the Competition Bureau should consider competition implications, the Office of the Superintendent of Financial Institutions should examine prudential considerations, and the Minister of Finance should rule on the merger based on overall public interest considerations. Mergers among Schedule I banks were expressly excluded from the analysis.[180]

As noted earlier, the Competition Bureau is the government agency responsible for applying Canada's competition laws. Its mandate includes obtaining compliance with the Competition Act and fostering "a climate of competition for

[180] A copy of the Interim Report is included in the final report of the Task Force.

the overall benefit of the Canadian economy and marketplace." The Bureau's authority extends to the financial services sector. However, its role is limited to concerns of a competition nature and does not generally include some of the other broad policy concerns raised by mergers and consolidation.

The second government agency involved in merger activities of federal regulated financial institutions is the Office of the Superintendent of Financial Institutions. OSFI is the primary supervisor of federally regulated financial institutions and assumes the responsibility of safeguarding policy holders, depositors and pension plan members from undue loss, with a view to maintaining public confidence in the financial system. Under federal legislation, the Superintendent has broad authority to supervise the activities of federally incorporated financial institutions. This includes, for example, the authority to issue directions to cease or carry out actions with regard to the safety and soundness of the institution. This authority applies in the case of mergers and other consolidation activities.

The final decision over merger transactions involving federally incorporated financial institutions rests with the Minister of Finance. Federal legislation gives the Minister broad and largely unfettered discretion in considering the approval of mergers and acquisitions involving federal financial institutions. Although there are no guidelines on how the Minister's discretion should be exercised in specific merger cases, many believe that a policy of prohibiting mergers among large financial institutions has prevailed at the federal level for some time.

After reviewing the recommendations of the Interim Report in the context of mergers among Schedule I banks, the Task Force concludes that the basic framework and process set out in July 1997 should apply to all financial sector mergers involving federally incorporated financial institutions, subject to modifications discussed in this chapter. The modifications include the following:

- A further elaboration of the specific factors to be considered in a review of whether a merger is in the public interest. In particular, costs and benefits to consumers and regional considerations should be explicitly included.
- Introduction of a Public Interest Review Process for mergers among larger firms.
- Authority for the Minister of Finance to obtain enforceable undertakings from parties to a transaction.
- Provisions intended to streamline the approval process in certain circumstances.

This chapter will:

- outline the basic framework and process for the review of mergers;
- assess the roles of the Competition Bureau, OSFI and the Minister of Finance in the review process and the nature of their interaction;
- outline the proposed Public Interest Review Process for mergers involving larger institutions; and
- describe legislative changes that will allow the Minister to take enforceable undertakings and that will streamline the merger process.

The Regulatory Review Framework

In Chapter 6, the Task Force concluded that there should be no automatic prohibition of mergers among financial institutions. Rather, all merger proposals should be reviewed on their merits, including mergers among Schedule I banks.

While there are many sources of competition in the financial services sector, there is still the concern that a merger involving firms with large market shares might allow the resulting entities to exercise market power through anti-competitive behaviour. The Task Force believes that the Competition Bureau is appropriately positioned to examine the potential anti-competitive implications of proposed mergers in the financial services sector.[181] The Bureau has the requisite technical expertise to analyse a transaction and the remedial tools to mitigate any negative competition impacts of a proposed merger.

Mergers of well-managed and well-capitalized financial institutions are unlikely to pose a threat to the safety and soundness of either the institutions involved in the transaction or the financial system as a whole. However, because there is a prudential concern in the financial sector, there needs to be a step not found in merger review in other industries. The regulator needs the ability to prevent, on prudential grounds, a merger that presents safety and soundness concerns even if there are no concerns from a competition standpoint. OSFI is well positioned to assess these concerns and it is appropriate for the Superintendent to provide prudential advice to the Minister of Finance, including recommendations on undertakings related to safety and soundness.

Given the importance of the financial sector to Canadians, an additional review of any proposed financial sector transaction from the perspective of the public interest is essential, and the Minister of Finance is the appropriate

[181] This view is supported by research conducted for the Task Force by Donald McFetridge in *Competition Policy Issues* (Ottawa, September 1998), p. 149. He concludes that the merger review process of the Competitive Bureau "is effective and can reasonably be expected to protect markets from mergers to monopoly or to dominance."

authority. The Minister must have not only the clear authority to approve or disallow a merger but the ability to tailor it where appropriate to ensure that the potential national benefits of the transaction are maximized and the potential costs are mitigated.

The decision of the Minister would ordinarily be made after receiving the views of the Competition Bureau and OSFI. However, flexibility should be built into the process to allow certain mergers to be dealt with on a streamlined basis. This would include exempting smaller transactions from a full-blown review and, in rare cases, allowing the Minister to deal with certain proposals on a streamlined basis if such expediency is in the public interest. The Task Force believes that transactions involving larger financial institutions should be exposed to a public review process that would assist the Minister in completing his public interest assessment.

The nature of the review process underlines the importance of information sharing among the parties responsible for reviewing mergers in the financial services sector. In its Interim Report, the Task Force recommended that:

> the Director of the Competition Bureau seek, and the parties to such transactions supply, a waiver under Section 29 of the Competition Act that would allow the Director to share information, subject to appropriate arrangements to protect confidentiality, with OSFI and the Department of Finance.

This recommendation appears to have been helpful in assisting the three key decision makers in dealing with merger transactions proposed in the last year. The Task Force continues to support the objective of information sharing among the three groups in order to ensure that appropriate decisions are made based on the best possible information available.

The roles of each of these players within the merger review process are elaborated in the following sections.

Competition Bureau: Competition

Corporate restructuring is driven by the need to conduct business in better ways. This includes, for example, finding more efficient ways of producing or delivering goods and services. In a competitive market, efficiencies gained by one firm will allow it to lower its price or improve its quality and gain market share. Competitors eventually discover the same efficiencies and meet the price or quality, thereby passing much of the benefits of efficiency on to consumers.

Mergers are one way of finding such efficiencies, for example through economies of scale and scope. The problem posed by mergers is that there may be less competition as a result of the transactions. Therefore, a key objective of merger review policy is the determination of whether a transaction will result

in a substantial lessening or prevention of competition. Industry consolidation which leads to real economic efficiencies but results in adequate competition will benefit consumers over the long run. The role of the Competition Bureau in examining mergers for their anti-competitive implications is a crucial part of the merger review process.

In 1991, the Competition Bureau set out its analytic framework for assessing whether a merger is likely to substantially lessen or prevent competition, in its Merger Enforcement Guidelines (MEGs). In a submission to the Task Force in November 1997, the Director of Investigation and Research provided his views on how the Bureau would likely apply those guidelines in assessing a merger involving two Schedule I banks. Following a thorough public consultation process, the Director released revised bank merger guidelines on July 15, 1998.[182]

The Task Force is of the view that the overall approach of the Competition Bureau to mergers in the financial sector is sound. The consolidation trend in the financial services sector will no doubt test the Bureau and its methods in a variety of ways. For this reason, the Task Force strongly supports the consultative approach adopted by the Bureau to examine the wide range of issues that arise in applying the Merger Enforcement Guidelines specifically to bank mergers. The following observations are intended to assist the Director in identifying and addressing the broader range of issues raised in the context of reviewing mergers more generally in the financial services sector.

Special Focus of Merger Review

Although the Task Force supports the overall direction of the Merger Enforcement Guidelines, including their proposed application to banking mergers, there are certain areas which may warrant greater focus as part of the Bureau's review. These include:

- the needs of small and medium-sized businesses, including access to credit and related small and mid-market retail financial services;[183]
- personal financial services which may still be branch-dependent and for which consumers may demonstrate a clustering behaviour in their purchase patterns, particularly around banking transactions accounts; and
- regional markets where there are fewer alternative suppliers and where there may be more practical non-regulatory barriers to entry.

[182] Competition Bureau, *The Merger Enforcement Guidelines as Applied to a Bank Merger* (Ottawa, July 1998).

[183] Our observations on the potential regional focus of retail banking and the possibility of clustering behaviour of consumers of retail financial services are of particular relevance (see Ch. 4).

Task Force research indicates that the wholesale market for financial services has largely become global in scope and should present no significant competitive problems.

Market Definition Approach

The Task Force endorses the market definition approach of the Competition Bureau. In assessing competitors and potential new entrants, the Bureau should consider the plethora of new competitive choices which already exist or which are emerging as a result of marketplace changes or liberalization of public policy constraints. In particular, the Task Force would like to draw the Bureau's attention to:

- the new unregulated and specialist providers that are emerging as competition to incumbent firms;[184]
- changing consumer preferences – for example, the increasing willingness of consumers to accept riskier, uninsured instruments (such as mutual funds) as substitutes for deposits;
- the evolution of non-bank financial institutions into competitors across traditional sectoral boundaries (an example would be life insurance and mutual funds as competitors in payments services if provided access to the payments system);
- the impact of technology on reducing barriers to entry and dramatically changing the geographic definition of markets;
- the increasing ability of consumers to seek services outside national boundaries and, similarly, the ability of foreign firms to enter Canadian markets with little or no physical presence; and
- the recommendations the Task Force has made to further expand competition in the financial services sector.

Although these developments are increasing the competitive options available to consumers, the Competition Bureau should also recognize that the changes do not necessarily ensure broader access for all consumers of financial services at the same rate. The Bureau should continue to be concerned about how quickly the new choices will provide effective competition in markets for customer segments such as low- and middle-income Canadians, small businesses (including start-ups), medium-sized businesses which are not yet able to access capital markets, users outside major urban centres, and older Canadians.

[184] Such providers include Countrywide Credit, Heller Financial, ING, Wells Fargo, MBNA, Capital One, State Street, Northern Trust, ADP, Ceridian, Newcourt Credit Group, GE Capital, The Associates and TransCanada Credit.

Remedial Options

The nature of the competition analysis conducted on a specific merger proposal by the Competition Bureau permits the Director to identify specific markets in which competition concerns may arise. That there may be concerns in these markets should not automatically defeat an entire proposal. The Bureau has at its disposal a range of options, such as requiring divestiture, to address these competition concerns in a manner that may allow a merger to proceed in substance. In a sector such as financial services, where there may be considerable concentration in specific markets, particularly at a regional level, these remedial options are important for increasing the range of solutions beyond the simple decision of whether to allow or deny the merger.

The Competition Bureau has had only minimal experience in using remedial options for transactions in concentrated markets.[185] In the case of financial institutions, it is not clear what interest there might be among competitors in purchasing aspects of a financial services business in the context of a divestiture. This should not dissuade the Director from pursuing those options.

The proposals of the Task Force directed at increasing competition in financial services should, over time, give the Director greater flexibility in the future to seek creative remedial solutions. In the meantime, the Director should look to merger proponents to assist in identifying practical remedial solutions in cases where the Director is concerned that a substantial lessening or prevention of competition would otherwise occur. In addition, the cooperative efforts of the Director and industry to identify solutions to competition issues should be pursued with a view to ensuring consistency with the broader public interest considerations that must ultimately be assessed by the Minister.

Access to Networks

Chapter 4 discussed the opportunities presented by the development of networks among industry participants, and noted the importance of ensuring that such networks serve to enhance rather than stifle competition. These are factors which the Competition Bureau may wish to take into consideration in assessing joint venture and other partnership arrangements. The Competition Bureau should continue to be vigilant, as it was in the Interac case,[186] in its scrutiny of industry networking arrangements and their potential impact on the competitive landscape of the financial services sector.

185 McFetridge, *Competition Policy Issues*, p. 39.

186 The investigation of Interac by the Competition Bureau led to the filing of an application (in the form of a consent order) with the Competition Tribunal alleging anti-competitive behaviour on the part of Interac and its members. *The Director of Investigation and Research v. Bank of Montreal, et al.* (1996), Competition Tribunal.

The Task Force expects that these types of arrangements will continue to grow in importance in the future. Issues will include not only ensuring access to the networks but identifying how full functionality may be achieved. For example, the Hongkong Bank of Canada, in a letter to the Task Force, urged that functionality in the Interac system be broadened to allow deposits to be made to any deposit-taking institution through an ATM, just as cash can now be withdrawn from any institution at any ATM.[187] This increase in functionality would enhance competition dramatically. The Hongkong Bank of Canada has also made this suggestion in a submission to the Competition Bureau. The Task Force believes it is worthy of serious consideration.

Resources

In light of the unprecedented changes taking place in the financial services sector, insufficient resources may be an immediate issue for the Competition Bureau. The Government should ensure that the Competition Bureau has adequate resources to secure the expertise required to carry out its responsibilities, including the secondment of financial sector experts and outsourcing where feasible.

OSFI: Safety and Soundness

The Task Force believes that the merger review practices of OSFI are satisfactory. However, its role in the review process should not be underestimated. The safety and soundness of the financial system and individual institutions are high public policy priorities in Canada.[188]

The role of OSFI should not be to ensure that regulated institutions never fail, including after a merger. This would be too stringent a test for merging institutions. Rather, part of OSFI's effort should be directed at identifying new prudential risks in mergers, particularly in the case of more complex, cross-pillar transactions. For example, OSFI may wish to review the moral hazard[189] implications of a merger, including the implications for the doctrine of "too big to fail."

An additional area in which OSFI's expertise may prove quite useful is in providing assistance to the Competition Bureau or the Minister of Finance in assessing or identifying restructuring alternatives.

187 Hongkong Bank of Canada, submission to the Task Force, letter dated May 21, 1998.

188 This more general issue of safety and soundness from a prudential regulation standpoint is discussed in greater detail in Background Paper #5.

189 Strictly speaking, moral hazard is the greater risk arising from the adverse impact an insurance contract has on the behaviour of the insured. For example, a person may be less inclined to take safety precautions with a fireplace if he or she knows that home insurance covers against any loss. In the context of the OSFI review of the merger, moral hazard refers to the greater prudential risk arising from a change in behaviour of the merging parties following the merger as a result of the benefits of being a regulated institution. The benefits may relate to being a regulated institution, to having access to a compensation plan or to being seen as "too big to fail."

Minister of Finance: The Public Interest

The final aspect of the merger review process is the exercise of discretion by the Minister of Finance to approve or disallow a merger. In its Interim Report, the Task Force concluded that the Minister "must assess the broad public interest considerations that ought to be brought to bear." The Task Force continues to support this general approach.

In the Interim Report, the Task Force pointed to a number of areas which should be given particular consideration by the Minister in conducting an assessment. These issues are discussed below in respect of mergers among Schedule I banks.

The potential impact of a merger transaction on the overall public interest grows as the size of the merging institutions increases. Once a decision is taken to permit a merger, it cannot be unwound. The Task Force has concluded there should be a more transparent and public review process in cases involving mergers among the largest institutions.

The Minister's discretion is not restricted to approving or rejecting a merger as proposed; conditions may be established under which the proposed merger might be allowed. Indeed, if the Minister is to treat merger proposals as an opportunity to reshape the industry for the benefit of all Canadians, the review process must be viewed as a means of identifying a range of creative options that increase the net benefit to Canada to be derived from the transaction. However, the Minister needs the clear authority to obtain legally enforceable undertakings backed by strong sanctions in order to mitigate public interest costs and to participate in brokering solutions for the benefit of Canadians.

The following section expands on these topics.

Public Interest Considerations

The list of public interest issues for the Minister to consider is not intended to be exhaustive. This section elaborates on the following considerations in the context of Schedule I banks:

- the costs and benefits to individual customers and to small and medium-sized businesses;
- regional impacts;
- international competitiveness;
- employment;
- the adoption of innovative technologies;
- precedential impact; and
- other public interest considerations.

1. Costs and Benefits to Individual Customers and to Small and Medium-Sized Businesses

The quest for economic efficiencies is one of the key drivers of restructuring in the financial sector. In a competitive market, the economic benefits of efficiencies, synergies and innovation can be passed on to consumers in the form of lower prices, better quality or greater choice. Even where it is found that a merger will not result in a substantial lessening or prevention of competition, it may be that the competitive structure of the market will not allow any of these benefits to flow to consumers. Moreover, a transaction may give rise to situations that are contrary to consumer-related public policy objectives affecting, for example, access to financial services or confidentiality of personal information.

What may be an efficiency gain for financial institutions could be a cost for consumers. Small and medium-sized businesses stress the importance of branches, and in particular the relationship with account managers, in ensuring reasonable access to banking services.[190] The impact that mergers have on branch access for important customer segments is an example of a potential cost of a merger which warrants special consideration in the context of a merger review.

Where the potential costs to customers of a proposed merger appear great, there is an onus on merger proponents to constructively address these concerns and, if the costs are real, to explore what measures might be introduced in order to mitigate them.

2. Regional Impacts

Despite Canada's challenging geography, the financial services sector has been able to provide consistent services to most regions of the nation. This is a strong national characteristic of the Canadian financial services industry and one which could be put at risk in the short run as financial institutions rationalize operations at home to remain internationally competitive.

Although it would not be beneficial to Canada for public policy to simply reject the objectives of international competitiveness in favour of regional considerations, these considerations should be carefully weighed in assessing mergers. Merger proponents should provide a clear explanation of what impact the transaction will have on regional markets across Canada, identify any special competition or other public policy issues of a regional nature, and outline what measures may be considered to address those affected the most. This may, for example, involve explaining how the application of technology and the implementation of new delivery channels will be employed to ensure continued access to financial services.

[190] Canadian Federation of Independent Business, *Submission to the Task Force on the Future of the Canadian Financial Services Sector* (October 1997), p. 8.

3. International Competitiveness

Chapter 5 discussed the benefits to Canadians of an internationally competitive financial services sector. An internationally competitive domestic industry is an effective way of ensuring that Canadians are getting financial products and services at prices and service levels which are the best the world has to offer.

The Minister is best placed to assess whether an individual transaction is consistent with the objective of longer-term international competitiveness of the financial services sector within the broader public policy context.

4. Employment

Efficiencies in mergers are often achieved through the elimination of overlapping functions, employment being a frequently cited example. The public policy implications for employment raised by the consolidation trend in financial services are serious, particularly given the large number of people employed by the sector. This issue cannot be treated lightly by policy makers. However, we must be careful not to assume that mergers are the sole cause of decreasing employment in financial services. It is important to understand why and how mergers affect employment.

Mergers are often a means of accelerating trends that are taking place in the industry. They are, in a sense, catalysts of change. A merger can help a company quickly achieve scale in a sector, a broader scope of products, wider geographic reach, and so on. Across an entire market, mergers can quickly help industries deal with economic challenges such as inefficient distribution systems. As noted in Chapter 2, the trend in financial services has been toward fewer but better-quality jobs. Even in the absence of mergers, trends such as outsourcing are facilitating this type of change. Accordingly, if one were to deny mergers solely on the basis of their negative implications for employment, this may only serve to delay the more fundamental economic trend in employment, diminish the competitiveness of institutions and prevent potential economic benefits from flowing to consumers.

As the skill mix of the financial services labour force adapts to reflect the changing needs of the economy, employees are expected to have better-quality jobs and to be better paid. An industry that offers better-quality and higher-paying jobs is beneficial to the Canadian economy. If Canadian financial institutions are not allowed an opportunity to evolve in the same way as their counterparts in other countries (subject, of course, to maintaining adequate competition and other relevant public policy considerations), their competitive position – at home and abroad – will potentially erode over time. This is a risk not just for Canadian financial institutions but for all Canadians.

Although mergers may only be catalysts of change, the immediacy of their impact on employment in an industry may nonetheless give rise to serious transitional social issues. In this context, merger proponents may be able to choose among viable options so as to mitigate the immediate employment consequences of their transaction in ways that do not necessarily jeopardize the long-term efficiencies that are to be gained from consolidation.

In its Interim Report, the Task Force made the distinction between direct and indirect employment impacts of a merger. A merger directly affects employment when the transaction has an immediate consequence, such as announced layoffs or intended employment reduction through attrition. An indirect impact on employment is a change in employment elsewhere in the work force as a result of the transaction. This may include, for example, changes in employment in *a)* competitors who pick up market share, *b)* suppliers who are affected by the restructuring, *c)* support firms whose services come under greater or lesser demand by the restructured firm, or *d)* customers. These indirect impacts also include any changes in the economy as a result of the contribution of the merger to overall market efficiencies (or inefficiencies) and economic growth.

The Task Force noted in the Interim Report that the short-term impacts of mergers on employment, both direct and indirect, are usually negative. Although the short-term employment impact of a proposed merger should be a factor considered in a merger review, together with any mitigating proposal identified by the merger proponents to offset the potential dislocation implications, the longer-term impact on employment is a key consideration. The focus should not be strictly on the number of jobs but also on the overall quality. It was noted earlier that mergers can lead to better-quality, higher-paying and, in some cases, more jobs in the longer term. These are jobs that could be lost to other countries if Canadian institutions are not given the opportunity to evolve in this manner. Merger proponents bear the burden of demonstrating these benefits and making constructive proposals to mitigate the costs.

It should be noted that mergers in which the longer-term benefits accrue in the form of indirect employment will be among the most challenging cases for proponents to put forward. An example might be a case in which efficiency gains give merged institutions the ability to acquire more services from outside suppliers, leading to more or better-quality jobs in the overall market. The challenge of demonstrating the benefits in these cases should not prevent these types of transactions from being proposed and considered.

5. Innovative Application of Technology

There are qualitative impacts to the innovative application of technology that go well beyond the efficiency gains already cited. The application of technology can lead to better-quality service and a broader range of choice for consumers. It can be responsible for a shift in skill sets resulting in higher-quality jobs. This in turn can lead to domestically based centres of technical expertise and excellence that might otherwise develop outside Canada.

An area where the innovative application of technology has proved to be quite beneficial to Canadians has been in the development of information network platforms that have given Canadians access to leading-edge banking services, such as debit cards and electronic money cards. The Canadian payments system, Interac and Mondex are examples of consortiums that have brought about the application of these types of technology innovations. Such developments are facilitated in an environment in which a small number of players are able to take a leadership role in developing the necessary systems and standards.

While industry consortiums may be conducive to the development of national technology platforms, the process should not result in the exclusion of smaller competitors from the market. Reasonable access to, and full use of, such networking platforms is essential to ensure adequate competition in emerging financial services. Although the Competition Bureau has the resources to police the strict anti-competitive implications arising from industry cooperation in the development of such platforms, the Minister is best positioned to see that the platforms are adopted and used in a manner that ensures the greatest overall benefit to Canadians.

6. Precedential Impact

Given the small size of the Canadian financial services market, decisions involving one transaction can significantly affect the overall structure of the sector. This can have serious implications for other competitors in the industry and for the Canadian consumer. While this alone should not be reason to stand in the way of change, it does point to the need for consideration of the impact a transaction may have on the options of other firms and the industry structure as a whole. This requires the Minister to consider individual transactions in the context of a broader perspective of what the financial services industry may look like over time.

7. Other Public Interest Considerations

This list of criteria is not meant to be exhaustive. Every significant merger proposal gives rise to its own unique set of public interest considerations that must be examined carefully by the Minister of Finance. The task of identifying and assessing these many public interest considerations in each individual case, and the measures to mitigate the costs, is not an easy one. The responsibility of identifying the public interest considerations and possible mitigating solutions rest with both the proponents of the merger and the Minister.

The Public Interest Review Process

The recent announcement of the proposed mergers among Schedule I banks has brought about intense public debate on the issue of industry consolidation. Research conducted for the Task Force suggests that the public in other jurisdictions is typically interested in financial sector mergers, although formal mechanisms to capture public concerns are not the norm.[191] The Task Force believes that public participation in the review of proposed mergers involving very large institutions is constructive and can lead to a greater awareness of the public interest costs and benefits of a specific transaction.

To ensure that Canadians have an opportunity to have their views taken into account, the Task Force proposes a Public Interest Review Process which would apply to mergers involving very large federally incorporated financial institutions. Such a process would provide a structured means of eliciting public input into the merger decision. As its objectives, this process should be:

- ***Transparent.*** It should permit the public to intelligently assess the costs and benefits of the proposal and provide comment as an input to the Minister.
- ***Efficient.*** It should not unduly delay the decision-making process. This would be accomplished by establishing a format and time frame for public input.
- ***Cooperative.*** Merger proponents and government share the obligation of identifying the public interest concerns and should work together to find solutions for the benefit of all Canadians.

The basic structure of the review process would be as follows:

First, the process would generally apply where two or more institutions, at least one of which is federally incorporated, enter into an arrangement to combine their activities to form an enterprise with shareholders' equity of more than $5 billion, and where each of the combining institutions has at least $1 billion of shareholders' equity. The Minister could also require it in other cases where he felt it would be helpful to his decision making.

[191] Jean Roy, *Mechanisms for Public Participation in Economic Decision-making*, Research Paper Prepared for the Task Force (Ottawa, September 1998), p. 44.

Second, the merger proponents would be required to submit a detailed Public Interest Impact Assessment that outlines their business plan and objectives, and identifies the public benefits and costs of the transaction. The Assessment should contain factual data and, at a minimum, should specify:

- the costs and benefits to individual customers and to small and medium-sized businesses;
- regional impacts;
- international competitiveness;
- employment impacts; and
- the adoption of innovative technologies.

The proponents should indicate in their Assessment what steps they are prepared to take to mitigate any undesirable effects of the transaction (e.g., divestiture options in non-competitive markets, commitments to small business or regions, and transition strategies in response to employment issues). The Assessement would be available to the public.

Third, there would be a reasonable time period for written public comment. Submissions would be made available for public review in a transparent manner.

Fourth, the decision of the Minister on the proposed transaction should be made as promptly as possible, following the public comment period.

The Public Interest Review Process is not intended to be a formal adjudication process. The process is intended to be cooperative. Merger proponents should work with the Minister, supported by the Director of the Competition Bureau and with input from OSFI, to arrive at solutions allowing the merger to be structured in a manner that is consistent with public interest goals. Although it will not be a simple task, the objective of this exercise will be to achieve a balancing of institutional interests (e.g., the achievement of substantial efficiencies and enhanced competitiveness) with public interests (e.g., continued competitive markets and the mitigation of public interest costs).

Enforceable Undertakings

In assessing any merger transaction, the Minister should have the authority to obtain enforceable undertakings to ensure that promises made to address public interest concerns are fulfilled by the merger proponents. This power should apply to all transactions requiring Ministerial approval.

Details of the regime will need to be worked out. However, the Task Force believes the regime should entail the following key requirements:

- The Department of Finance with the assistance of OSFI should monitor compliance with the undertakings and report regularly to the Minister.

- Federal financial institutions legislation should be amended as necessary to give the Governor-in-Council, on the recommendation of the Minister, the authority to issue directions in respect of undertakings provided to the Minister, including the direction to cease and desist from committing an act, or to perform such acts as in the opinion of the Minister are necessary to remedy a situation where undertakings are not being met.
- Such directions should be enforceable by the courts.
- There should be clear sanctions for failure to comply with an undertaking, including substantial fines for financial institutions, officers and directors. Additional criminal sanctions would apply for officers and directors of financial institutions that fail to comply with a direction of the Governor-in-Council.

Streamlined Merger Process

It is important that the proposed review process not become an unnecessary deterrent to merger transactions. In particular, smaller transactions which pose little threat to the public interest need not be subjected to the same review process as larger firms.

Merger transactions involving financial institutions which do not meet the qualifications of a Public Interest Review Process would still be subject to approval by the Minister in accordance with the process outlined earlier. However, for transactions not subject to pre-notification under the Competition Act, OSFI should provide final approval when the acquirer is another federally incorporated financial institution. Such small acquisitions do not give rise to competition concerns, and they do not raise the same public interest concerns as larger transactions. Ministerial approval should still be required for small transactions if the acquirer is not a federally incorporated financial institution, thus ensuring that the "fit and proper" test is met consistent with the requirements for a new incorporation.

In addition to the measures noted, the Minister should be empowered to exempt any parties to any transaction from the requirements set out above when, on the recommendation of OSFI, the Minister is of the view that expeditious completion of the transaction is in the best interest of the financial system. This exemption should not have general application, but is intended to deal with a failing firm or other threat to the stability and soundness of the financial system.

Chapter 8

Canadian Control

Ownership provisions in Canadian financial sector legislation have been written to achieve two main public policy objectives: safety and soundness, and Canadian control. This chapter deals with the latter of these objectives.

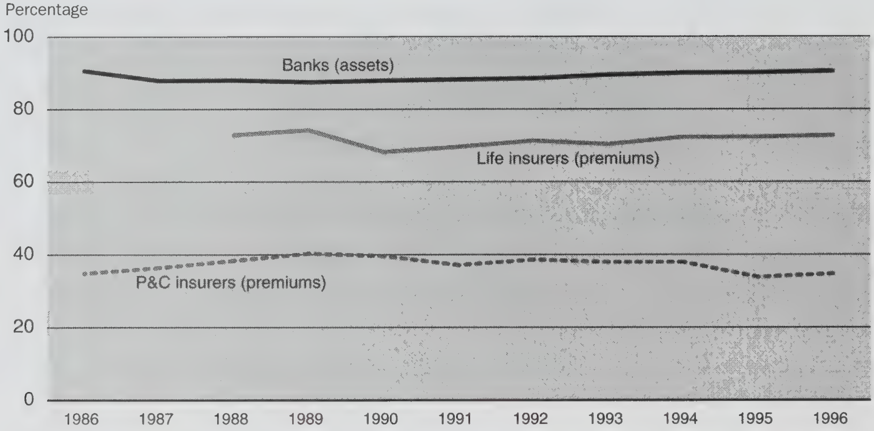
Both Canadian and foreign-controlled industries contribute significantly to our economy. They both employ Canadians, purchase Canadian goods and services, pay taxes to Canadian governments and make investments in the Canadian economy.

Does it matter whether an industry is Canadian-controlled? At a time when countries are reeling from the impact of international market forces, domestic control of an industry may provide us with some degree of influence over at least a part of our economic destiny. There may also be more visible and direct benefits. Key strategic industry decisions affecting Canadian consumers are likely to be made from a domestic perspective. Head offices and corporate operations are more likely to be based in Canada, with implications for employment, procurement patterns, tax revenues and domestic profit retention.

In some sectors, governments have adopted regulatory policies which favour or even require Canadian control. These policies have a restrictive impact on market behaviour. In these cases, it is presumed that the benefits to society of Canadian control outweigh the economic costs arising from the underlying market restriction. This cost-benefit analysis is at the heart of the Canadian control issue in financial services.

Much of the Canadian financial services sector remains under Canadian control (see Exhibit 8.1). With advances in technology and increased globalization, international firms find it easier to set up their operations in Canada and, indeed, Canada seeks out and encourages foreign investment. International trade agreements open doors to greater foreign entry as they codify Canada's trade interdependence with other nations.

Exhibit 8.1
Market Share of Domestic Institutions in Canada



Source: The Conference Board of Canada.

It is important to note, though, that none of these international trade agreements imposes on Canada the obligation to treat foreigners more favourably than Canadians. Accordingly, Canada's trade obligations do not threaten current ownership regulations since these do not discriminate on the basis of nationality.

This chapter will:

- examine what is meant by the term "Canadian control";
- explore why Canadian control is important;
- identify the rules which have contributed to the Canadian character of the financial services sector; and
- present the framework for an ownership regime which will ensure that the benefits of Canadian control are maintained.

What Is "Canadian Control"?

It is easier to point to examples of Canadian control than to define what is meant by the term. In financial services, Canadian control generally refers to domestic control of an institution at the governance, rather than the ownership, level. The reason is that public policy is concerned with the impact of industry conduct on Canadians, as determined at the governance level.

One way to ensure Canadian control at the governance level is to require Canadian ownership of institutions. Policies such as the former 25 percent aggregate limit on foreign control of bank shares certainly ensured that a majority of

shareholders of a Schedule I bank were Canadian. Financial sector regulation has gradually shifted away from requiring Canadian ownership of financial institutions. (See Exhibit 8.2 for a history of ownership restrictions in Canada.)

Exhibit 8.2
History of Foreign Ownership Restrictions on Financial Institutions

Banks

- **1967** – Federal government imposes a "10/25" rule, restricting any one person from owning more than 10 percent of a bank. Foreign interests could not collectively own more than 25 percent of the shares of a bank. No foreign bank subsidiaries permitted.
- **1980** – Foreign banks permitted to enter Canada through subsidiaries, but not to acquire an existing bank.
- **1989** – Pursuant to the Canada-United States Free Trade Agreement (FTA), the 25 percent limit on foreign share ownership was removed for U.S. residents.
- **1993** – The 25 percent limit was also removed for Mexican residents in 1993 pursuant to NAFTA.
- **1994** – The 25 percent limit was removed altogether pursuant to Canada's commitment under the Uruguay Round of trade negotiations. The 10 percent restriction remains for all Schedule I banks.

Federal life insurers

- **1950s** – Government encouraged life insurance companies to become mutually owned by their policy holders, preventing a foreign takeover of these institutions. Today, four of Canada's largest life insurance companies are mutually owned.
- **1965** – Ownership of Canadian-controlled, federally incorporated life insurance companies is restricted for non-residents: 10 percent for any individual and 25 percent for all non-residents. Foreign residents may start up new life insurance companies or purchase foreign-controlled life insurance companies.
- **1989** – 10/25 restriction on federal life insurance companies lifted for U.S. residents pursuant to FTA.
- **1993** – 10/25 restriction removed for Mexican residents pursuant to NAFTA.
- **1994** – 10/25 restriction removed altogether pursuant to the Uruguay Round of trade negotiations.

Federal general insurers

- There have generally been no restrictions on the foreign ownership of federally incorporated property and casualty insurance companies in Canada.

Exhibit 8.2 (continued)

Federal trust and loan companies

- **1965** – Ownership of Canadian-controlled, federally incorporated trust and loan companies is restricted for non-residents: 10 percent for any individual and 25 percent for all non-residents.
- **1980** – In setting up the federal foreign banking regime, the federal government essentially required that any foreign deposit-taking institution enter the Canadian financial services market under the Bank Act, which effectively precludes them from owning Canadian trust and loan companies.
- **1989** – 10/25 restriction removed for U.S. residents pursuant to FTA.
- **1993** – 10/25 restriction removed for Mexican residents pursuant to NAFTA.
- **1994** – 10/25 restriction removed altogether pursuant to the Uruguay Round of trade negotiations.
- **1997** – Foreign deposit-taking institutions permitted to own Canadian trust and loan companies (as opposed to being required to set up through a foreign bank subsidiary).

Securities dealers

- **up to mid-1980s** – Stock exchanges and the Investment Dealers Association of Canada applied restrictions on the foreign ownership of securities dealers. A restriction similar to the 10/25 rule was eventually removed during the mid-1980s.

Although not entirely explicit, Canadian control has been a part of public policy in the financial services sector since at least the 1950s, when life insurance companies in Canada were encouraged by government to become mutually owned. The wide ownership of banks was enshrined in statute in 1967. Our obligations under the North American Free Trade Agreement (NAFTA) and to the World Trade Organization have resulted in the elimination of restrictions on foreign ownership of domestic institutions. But protection of Canadian control at the governance level has largely been preserved, mainly through wide ownership rules that prevent individual interests, both foreign and domestic, from controlling Canadian-based institutions.

For the purposes of this chapter, the Task Force has adopted the following functional definition of "Canadian control" in the financial sector:

> A financial institution managed by Canadian-based executives subject to Canadian governance requirements and not subject to the influence of a dominant foreign interest.

It follows that an industry is Canadian-controlled when it is made up primarily of firms which are themselves Canadian-controlled.

The Policy Case for Canadian Control

No single argument is sufficiently persuasive to justify retaining Canadian control as a public policy objective. Rather, it is the weight of argument which leads the Task Force to conclude that it is not appropriate to abandon such a policy.

Public Support for Canadian Control

Canadians overwhelmingly support a continued policy of Canadian control in the financial services sector.

In a survey conducted for the Task Force, 82 percent of Canadians indicated that it was important to have Canadian control of domestic banks even if it meant slightly higher prices. Seventy percent felt the same way about insurance companies. Fears of job losses, the importance of the financial sector to the economy, the need to protect consumers and the ability of government to regulate are strong factors in shaping those opinions.[192] This view was strongly reinforced in the submissions received by the Task Force.[193]

International Precedents

Canadians are in good company in their interest in preserving domestic control over major financial institutions. In fact, few countries have allowed major parts of their financial sector to come under foreign control, particularly their major banks.[194] Michael Mackenzie, the former federal Superintendent of Financial Institutions, made this point with respect to banks in his submission to the Task Force:

> This pattern of domestic ownership of the banking system is a feature of all developed countries, even though they all are open to foreign competition. I also think that domestic ownership of clearing banks is important to the Treasury, Finance and central banking authorities around the world because of the importance of such banks to their economies and payment systems. *Not one of the developed countries would allow any of their major clearing banks to be controlled by foreigners*, even though there may be no laws in place to prevent a takeover [emphasis added].[195]

[192] Ekos Research, *Public Opinion Research Relating to the Financial Services Sector* (Ottawa, September 1998), pp. 51, 52.

[193] Out of over 250 submissions received by the Task Force, only a handful entertained the possibility of abandoning Canadian control as a public policy objective.

[194] New Zealand appears to stand alone among developed countries in having a majority of its banking sector foreign-controlled. As a result, New Zealand has abandoned its direct supervisory role in favour of a public disclosure model.

[195] Michael Mackenzie, "Comments on the Discussion Paper Issued June 13, 1997," submission to the Task Force (August 1997), p. 5.

The Financial System Inquiry in Australia also reached similar conclusions concerning that country's entire financial sector:

> The Inquiry does not consider that a large scale transfer of ownership of the Australian financial system to foreign hands would be in the national interest. Such an eventuality could restrict the options for the future development of the financial system and Australia's place in the regional and global economy.[196]

While many countries do not have explicit ownership restrictions on their major financial institutions, they generally retain the authority to approve major changes in ownership.[197] It would appear that the discretionary powers of government play an important role in other jurisdictions in maintaining a policy of domestic control over the financial sector.

Benefits of Canadian Control

1. Financial Centre Benefits

Among the more persuasive arguments for retaining Canadian control are the benefits derived from the continued existence in Canada of a financial centre. The argument hinges on the phenomenon of industry clustering. International examples are observed in other industries: the automotive industry (Detroit), film-making (Los Angeles) and software manufacture (Silicon Valley).[198] Research and experience suggest that clusters benefit industry in a number of ways:

- interaction among peers as a result of proximity;
- scale to support a sophisticated, closely linked supplier base;
- access to specialized skills and a large talent pool;
- the ability to stay attuned to industry dynamics; and
- innovation through close competition and idea exchange.[199]

One of the key benefits of a financial centre is higher-quality, skilled jobs. One research report estimates that up to 55 percent of all financial services jobs in the Greater Toronto Area (GTA) could easily be transferred away from Toronto through the introduction of new technologies.[200] This includes transfers to outside Canada. A good portion of those jobs might not even exist in Canada were it not for the existence of the financial centre in the GTA.

196 *Financial System Inquiry Final Report* (Melbourne, Australia, March 1997), p. 474.

197 James Barth, Daniel Nolle and Tara Rice, *Commercial Banking Structure, Regulation, and Performance: An International Comparison* (February 1997), Table 4.

198 The Boston Consulting Group, *Financial Services at the Crossroads: The Current and Potential Role of Financial Services in the Greater Toronto Area* (January 1997), p. 16.

199 Ibid., p. 18.

200 Ibid., p. 23.

Likewise, in the absence of a financial services cluster around Toronto, the indirect employment industries that support financial services would also not be as strong. The Boston Consulting Group puts that employment at about 158,000, roughly the same as the number of employees directly employed by the financial services sector in the Greater Toronto Area (165,000).[201]

A policy of Canadian control goes some distance toward ensuring that a sufficient critical mass of domestic institutions remains headquartered in Canada to support a domestic financial centre.

2. Taxation Revenue

Taxation revenues are another argument for having strong, Canadian-based financial services conglomerates headquartered in Canada. All financial institutions combined paid a total of $8.36 billion in federal, provincial and municipal taxes in 1996.[202] This figure would most likely be lower if more institutions were not Canadian-based and more of the business was booked outside Canada in parent companies domiciled elsewhere.

3. Domestic Market Sensitivity

Some argue that a domestically controlled firm will be more sensitive to domestic economic and political circumstances, and would be less likely or able to "withdraw" from the Canadian market in the event of destabilizing forces.[203] Canadian institutions might find it more difficult to withdraw from Canadian markets than would foreign banks. There have certainly been a large number of foreign banks and insurance companies in the last decade that have elected to exit from the Canadian market.

Related to this is the view that Canadian institutions would be more susceptible to moral suasion by Canadian governments. However, it can be argued that any foreign financial institution with capital committed in Canada is likely to be as susceptible to such influences as a domestic firm.

Strong domestic financial institutions make a substantial contribution to Canadian communities, through philanthropy and community leadership. Examples of their contribution, and how it can be broadened and deepened, are discussed in Background Paper #4.

[201] The Boston Consulting Group, *Financial Services at the Crossroads*, p. 4.

[202] Chris Roth and Hugh Williams, *The Canadian Financial Services Industry: The Year in Review, 1997 Edition* (Ottawa: The Conference Board of Canada, December 1997), p. 22.

[203] A U.S. study found that Japanese banks, hit by a decline in their stock value in the late 1980s, significantly reduced their loan portfolios in the United States to come in line with capital requirements while their domestic portfolios were protected from shrinkage. The authors attribute the domestic preference to close lending relationships in Japan. Joe Peek and Eric Rosengren, "The International Transmission of Financial Shocks: The Case of Japan," *The American Economic Review*, vol. 87, no. 4, (September 1997), p. 495.

4. International Presence

As a smaller member of the increasingly integrated global community, Canada will derive part of its economic and political clout among its peers from the presence of Canadian business in international markets. Canada has done well in producing internationally competitive institutions despite a small customer base. However, the worldwide trend toward even larger companies – as shown in the recent merger announcements in the financial services, automotive and telecommunication industries – means Canadian firms will be increasingly outscaled by global giants. The financial services sector is arguably among the more important areas where a strong international presence by Canadian-controlled firms can be advantageous.

5. Diminished Extra-Territoriality

It is also argued that Canadian-controlled institutions are less subject to the extra-territorial application of foreign laws than subsidiaries of foreign institutions. Having strong Canadian-controlled financial institutions provides us with greater protection from foreign policies that adversely affect Canadian interests.

Costs of Canadian Control

There are potential costs to a policy of Canadian control, particularly if such control is achieved through a policy of wide ownership.

One of the arguments made is that wide ownership, achieved through such restraints as mutual company models and the 10 percent ownership restriction, limits the flexibility of financial institutions to use equity as part of growth strategies. Mutual companies lack the ability to access equity markets. Schedule I banks cannot issue share blocks in excess of 10 percent to a single shareholder as part of an acquisition. It has been further argued that the wide ownership rules undervalue equity because of the inability of shareholders to command a takeover premium. This, it is claimed, reduces the value of shares as acquisition "currency" in purchasing other firms.

The Task Force recognizes the potential limiting effects of a wide ownership policy. For this reason, the Task Force proposes a more flexible wide ownership policy that will give financial institutions greater scope to use equity as part of their growth strategies.

As for the impact of wide ownership rules on share value, research conducted for the Task Force concluded that there is no direct evidence that the 10 percent rule applicable to Schedule I banks adversely affected their share price.[204]

[204] The Task Force commissioned research to assess the economic impact of what is generally considered the most restrictive of the wide ownership regimes, namely the 10 percent rule applicable to Schedule I banks. Gerald Garvey and Ron Giammarino, *Ownership Restrictions and the Value of Canadian Bank Stocks*, Research Paper Prepared for the Task Force (Ottawa, September 1998).

If there is a value effect on shares, the more flexible wide ownership regime proposed by the Task Force should lower these undervaluation impacts.

A last argument is that wide ownership removes the effective shareholder oversight of management on boards of directors. While there may be some truth to this argument, there is evidence that boards of directors and management of widely held, publicly traded financial institutions are subject to considerable pressure from the markets to perform in the best interests of shareholders.

The next section examines the regulatory tools which currently preserve some degree of Canadian control in the financial services sector.

Current Canadian Control "Toolkit"

Canadian control is rarely identified as an explicit objective of financial sector regulation. However, it is clear that Canadian regulatory policy has had the effect of ensuring some degree of domestic control over the various segments of the financial sector. The most effective tool employed in Canada to achieve this policy objective has been wide ownership rules.

Most financial sector firms operating in Canada have no controlling shareholders. This includes Schedule I banks, credit unions, caisses populaires and mutual insurance companies. Since no individual owner exercises control, Canadian control of these institutions is independent of nationality of ownership. In fact, a widely held financial institution can still be Canadian-controlled in this sense, even if a majority of its shares are held outside of Canada. An example of this might be a mutual insurance company that has a majority of foreign participating policy holders but is nonetheless governed by Canadians.

Ownership policies are powerful tools for achieving Canadian control, but they are also quite blunt in their impact. There is no guarantee that a Canadian incorporated financial institution that is closely controlled by Canadian interests or subject to a wide ownership regime will always have a Canadian-focussed management team or a meaningful presence in Canada. For this reason, most Canadian financial sector legislation includes provisions which impose some degree of Canadian perspective at the governance level. A list of Canadian control tools contained in federal financial institutions legislation is featured in Exhibit 8.3.

Individually, these legislative requirements do not guarantee Canadian control at the management level. As a whole, however, this Canadian control "toolkit" can have a strong impact, particularly in widely held institutions where there is no dominant shareholder.

Exhibit 8.3
Canadian Control Toolkit

The following features of legislation related to federally incorporated financial institutions contribute to the Canadian character of domestically based financial institutions in addition to ownership rules.

Head office – The head office of federally incorporated financial institutions must be located in Canada.

Shareholders' meetings – Shareholders' meetings are required to be held in Canada.

Director residency – Three quarters of the directors must be resident Canadians (the proportion is reduced to one half in the case of a foreign-owned bank or other financial institution).

Residents at meetings – No business may be transacted at a meeting of the board of directors or at a meeting of any committee of directors, even where a quorum is present, unless more than half of the directors present are resident Canadians (one half in the case of a foreign-owned bank or other financial institution).

CEO residency – The chief executive officer of the bank must ordinarily be resident in Canada.

Key documents – Important corporate and transactional documents must be kept in Canada. These include letters patent, by-laws, minutes of meetings and resolutions of shareholders and directors, accounting records, and customer information.

Federal approval – Changes to the letters patent and important changes to the by-laws (such as changes to the share structure or location of head office) require, respectively, Minister's or Superintendent's approval.

The Task Force has concluded that the elements of Canadian control outlined above are adequate with one possible exception: the requirement that the head office of a federally incorporated financial institution be located in Canada. There is no definition of the term "head office," and it appears that token compliance may satisfy this requirement. The Task Force believes it important that the legislation require a genuine head office in Canada at which the principal executive functions of the financial institution are carried out. Legislative amendments to that end would be appropriate.

Proposals for Canadian Control

The Task Force is persuaded that a substantial shift of control over Canadian financial assets to foreign interests would not be in the best interest of Canadians. In particular, the Task Force does not support any change in public policy that would place Canada in the position of exposing its financial sector to a sudden shift to foreign control – something no other country has done. However, a policy of Canadian control does not mean that the whole sector must be Canadian-controlled.

The Task Force recognizes some of the limiting implications of a policy of wide ownership, including:

- inflexibility in raising capital and issuing equity;
- its effect on corporate governance; and
- its impact as a barrier to entry.

The Task Force believes that it is possible to design a more flexible ownership policy that preserves the benefits of wide ownership, including Canadian control, while reducing some of the costs. Such a regime, would have the following key features:

- The policy of wide ownership would be aimed at only the largest federally incorporated institutions in the financial services market. A more flexible ownership regime would apply to smaller firms in order to encourage competition from new entrants, including foreign firms.
- The wide ownership restrictions would be sufficiently flexible to permit suitable shareholders to take positions from time to time in excess of the traditional wide ownership thresholds (i.e., the 10 percent restriction on Schedule I bank shares), subject to Ministerial approval. This would provide financial institutions with greater flexibility to enter into business alliances and acquisitions (including arrangements involving the issue of shares), while at the same time offering the potential for more constructive shareholder contributions to corporate governance.
- The policy should include the ability of the Government to permit foreign widely held and regulated financial institutions to own widely held domestic financial institutions in exceptional circumstances, when it would be in the best interests of Canadians.
- The position of existing firms should not be prejudiced by the new ownership policy. Their ownership circumstances and commercial options should be preserved.

A proposed ownership regime for federally incorporated Canadian financial institutions that contains these features is set out and discussed in Background Paper #2.

Chapter 9

Summary

In examining the tension that exists between the competing objectives of regulation, competition and international competitiveness, this paper began with an overview of the market forces which are driving change in the financial sector. Globalization, technology coupled with innovation, demographic changes and economic factors are driving structural changes at both the institutional and the market level.

To ensure that these structural changes occur in a way that is least disruptive to financial services markets and that provides maximum benefits to Canadians, the Task Force concluded that barriers to entry in all financial segments from any potential competitors must be reduced. To this end, the Task Force has proposed a four-point competition strategy for financial sector regulation. The strategy is intended to improve overall competition without compromising key public policy objectives, as follows:

1) greater competition among existing players;
2) greater competition from new players;
3) greater competition from foreign competitors; and
4) improved disclosure and redress mechanisms for retail consumers.

This strategy will ensure that industry restructuring takes place in an environment in which there is maximum opportunity for greater competition.

In exposing our financial services market to greater international competition, Canadian regulatory policy must not unduly disadvantage our domestic financial institutions. To do so would ensure the gradual erosion of their business franchises. This would not be in the best interest of Canadians. The Task Force proposes a number of changes that are intended to put domestic institutions on a level competitive playing field with their international competitors. These proposals include, but are not limited to, changes to the taxation regime and accounting conventions.

Some limitations on the market activities of financial institutions are necessary for public policy reasons, even though they affect competition. In particular, as market forces drive institutions to seek economies of scale and other economic

efficiencies, the resulting corporate restructuring should not undermine such objectives as competitive markets, a safe and sound financial system, and the public interest.

Public policy should seek to enable industry restructuring in a manner that balances public policy goals with the competitiveness objectives of the financial sector. For this reason, the Task Force has proposed a cooperative, transparent and efficient merger review process to ensure that the key public policy concerns arising from industry restructuring are considered. The process will provide merger proponents and government with the opportunity to harness the forces of change in a way that will ensure that Canadians as a whole benefit from industry restructuring, and that Canadian financial services firms continue to be strong competitors both domestically and internationally into the next century.

The Task Force has concluded that it would be in the best interests of Canadians to preserve Canadian control of the financial sector, although this does not necessarily mean domestic control of all financial institutions.